IMPACT OF PAYROLL TAXES ON SMALL BUSINESS

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

WASHINGTON, DC, MARCH 15, 1990

Printed for the use of the Committee on Small Business

Serial No. 101-47

U.S. GOVERNMENT PRINTING OFFICE

27-725 ⇆ WASHINGTON : 1991

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

H721-21

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IMPACT OF PAYROLL TAXES ON SMALL BUSINESS

THURSDAY, MARCH 15, 1990

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to notice, at 10:30 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Chairman LAFALCE. The Small Business Committee will come to order. Today we will be addressing a subject which has become one of the major topics of concern in Washington this year: payroll taxes. Our four witnesses are all experts in economics, tax, fiscal, and Social Security policy, and I know that my colleagues join me in looking forward to hearing their views.

Many believe that the concern about payroll taxes is a new one. But the fact is that many individuals have been working on this question for a long time. As an example, I, myself, introduced a bill back in 1979 which would have removed the Medicare and Disability Programs from the payroll tax, which I consider to be the most regressive tax we have, and funded them from general revenues.

My rationale for that proposal, which I introduced frequently over the years, was that these programs—unlike the retirement element—bear little, if any, relationship to the amounts contributed by individual taxpayers through FICA taxes and therefore would be more logically financed by a less regressive source of revenue, hopefully a progressive source of revenue.

I am hopeful that this hearing will help us learn more about the issues that surround the debate over payroll taxes in the American economy. We will gain some historical insights into payroll taxes and the Social Security System and discuss a number of questions, including whether and the extent to which payroll taxes are regressive, their impact on small businesses, whether they constitute a tax on labor and, if so, whether such a tax is appropriate.

Do payroll taxes disproportionately hurt smaller enterprise? Are they inflationary, et cetera?

Another issue which the committee would like to explore is the question of whether the Social Security Program—revenues or benefits, or both—ought to be treated differently from other parts of the Government in terms of calculating the deficit or in other ways.

Small businesses have a substantial interest in this subject, of course. Smaller businesses tend to be more labor-intensive than

larger enterprises, and therefore payroll taxes are disproportionately important to this sector.

Average wages and salaries in smaller businesses are less than in large businesses, meaning that less of the aggregate payroll in the small business sector would be above the $51,300 cap beyond which FICA taxes are not paid. For both these reasons, it could well be that small businesses are paying a very unfair share of the Nation's taxes.

[Mr. LaFalce's statement may be found in the appendix.]

Chairman LAFALCE. Before I proceed with the panel, do any other members of the panel wish to make any statements? Mr. Hoagland?

Mr. HOAGLAND. Thank you, Mr. Chairman. I appreciate your recognizing me. I appreciate the testimony we are going to hear this morning. Unfortunately, we are having a hearing over in the Financial Institutions Subcommittee, the Banking Committee on Oversight, which is very important.

I will not be able to stay very long, but I will take with me the statements of the witnesses this morning and review them, along with the chairman's statement, and I certainly appreciate the fact that all of you are here on these very important issues.

So many times we have to be three places at once in this job, and unfortunately it goes with the territory, but thank you again for coming. Thank you, Mr. Chairman.

Chairman LAFALCE. Thank you. Mr. McDade had a statement. Do you have his statement, Mr. Hancock?

Mr. HANCOCK. No.

Chairman LAFALCE. If there is no objection, I would like permission to put Mr. McDade's statement in the record immediately following mine. Without objection, so ordered.

[Mr. McDade's statement may be found in the appendix.]

Chairman LAFALCE. Then I will recognize Mr. Hancock for any statement he would like to make.

Mr. HANCOCK. Thank you, Mr. Chairman. I picked up some information the other day. Quite frankly, I wish I could stay for the entire hearing, because there are a lot of questions that I would like to ask specifically of Mr. Myers. In fact, he was very involved in the initial drafting of the Social Security System.

I happened to pick up a copy of the original documentation of how Social Security was advocated and how it was publicized in the 1930's. I think it is real interesting, and I would like to read a couple of excerpts.

One of them, titled "Your Part of the Tax," explains the FICA tax. It says that "you and your employer will each pay a ½ cent more for 3 years and finally, beginning in 1949, 12 years from now, you and your employer will each pay $.03 on each dollar you earn up to $3,000 a year. That is the most you will ever pay."

This is an official Government document that was used in 1936 to convince people that, in fact, yes, Social Security was a retirement plan.

Now, we are saying that Social Security is only supposed to be a supplement. That is all it is.

Reading on, this pamphlet says "what you get from the Government plan will always be more than you have paid in taxes and

usually more than you can get for yourself by putting away the same amount of money each week in some other way."

We told the American public in the 1930's, let Government provide your retirement. Now we are saying that this is not a retirement, this is just a supplement. This document convinced people to rely on Government rather than to rely on yourself and self-responsibility.

Mr. Chairman, I think that this subject should be brought to the attention of the American public. I think we should go back and take a real good look at how Social Security was originally advocated and promoted. To see how it has ended up being the highest tax that the average person pays.

I believe that we mislead the American public, and I think that we have to work to find a way to regain the trust of the American public. Thank you, Mr. Chairman.

[The material referred to may be found in the appendix.]

Chairman LAFALCE. Thank you very much, Mr. Hancock. Before proceeding, let me deal with some housekeeping matters.

First, we have one panel today with four witnesses, and my intent is to ask each panelist to make his statement first, before we have questions, and then to open it up for questions.

Second, the House is going to be in session today starting at 11 a.m. The bells you just heard indicated that it is 15 minutes until the beginning of the session. I hope we will not be called away for any votes. If we do, we will just have to hustle over and get back as quickly as we can. We will make every effort to minimize the inconvenience.

Third, and last, because of the limited time available and the desire to reserve time for questions for the members, I would ask that the witnesses limit their presentations to no more than 10 minutes. That would be a full 40 minutes. It will be at least 45 with interruptions, I am sure.

Your full statements, of course, will be entered into the record. In fact, we will do that now, if there is no objection.

No objection, so ordered.

With that, our first witness will be Mr. Robert Myers. I can't list all of Mr. Myers's accomplishments because it would take too long. Suffice it to say that he was there at the beginning on the staff of the Social Security Administration in 1934, and for 23 years he was the chief actuary there.

He spent some time teaching at Temple University but then came back to public service, where he has been Deputy Commissioner of the Social Security Administration and Executive Director of the National Commission on Social Security Reform in 1983. He was there as the Executive Director at the time of the great compromise and the great compact, and he is a worldwide consultant in actuarial and social insurance issues.

It is perhaps an understatement to say that Robert Myers is one of the foremost experts on Social Security in the Nation, and we are honored indeed that he has found time to join us today. Mr. Myers, our first witness.

TESTIMONY OF ROBERT J. MYERS, FORMER DEPUTY COMMISSIONER OF SOCIAL SECURITY, U.S. SOCIAL SECURITY ADMINISTRATION AND FORMER EXECUTIVE DIRECTOR, NATIONAL COMMISSION ON SOCIAL SECURITY REFORM

Mr. MYERS. Thank you, Mr. Chairman, for that very kind introduction.

Before getting to the subject on hand, I should respond a little to Mr. Hancock. First of all, I was not responsible for some of the things that he read there, which he quite rightly criticized. I can't prove it, but I think that some of the other actuaries who were with the Social Security Board in the original days, as well as myself, tried to get our public relations people to calm down the presentation a bit, but they didn't. They obviously were trying to sell the program. What they said was not entirely wrong, but it wasn't entirely right, either.

Certainly the cost has been higher than what was originally estimated, in part because the program was expanded to include hospital insurance under Medicare and disability benefits.

So with that, I will turn to the subject on hand. As I say, I have written in the past about what I consider to be some of the slight excesses of enthusiasm that some of the publicity people did in the early days to try to convince the American public that the Social Security Program is a good one.

I believe it is a good one. I strongly support it, but even if you do like something, you can sometimes oversell it, and I would agree that some of that publicity did go on in the early days under the name of education.

Social Security has always been financed by payroll taxes, and I think that's the right way to go. I think that, to put the cost out in the open visibly so that people see it, is desirable. This prevents over-liberalizations.

Some people in the past and in the very early days proposed that a very substantial part of the cost of the program should come out of general revenues. There is not so much of that talk anymore because there are far less general revenues available than there were before, and even then there never was a great amount.

But if general revenues go into the system, I think there are poor controls and over-liberalizations are possible, because people will say increase the benefits and just put more in from general revenues, as though that comes down like money from heaven.

There has always been equal employer and employee tax rates for Social Security. There is no actuarial reason for that. It just seems to make good aesthetic logic, that the employer and the employee pitch in equally to support the program.

The basis of taxation for the self-employed for a number of years was on an arbitrary basis. The 1983 amendments, partly to raise money and partly for logic, provided that the self-employed will be taxed in just the same way as if the self-employed person were incorporated.

In other words, the full employer/employee rate would be paid, but half of the tax could be considered as a business expense, just as a corporation can do.

There is a maximum earning base on which these taxes are paid, and because of this, many people say that the tax is regressive, because if the rate is measured against the total earnings for people above the base, it is lower.

With all due respect, Mr. Chairman, I think that the system is not a regressive one when it is looked at in its entirety. If one just looks at the tax, admittedly, it is regressive above the base.

But if one looks at the system as a whole, the benefits and the tax as a package, the system is definitely progressive up to the maximum earnings base, because of the heavy weighting in the benefit formula for lower-paid people, and above the earning base everybody pays the same and gets the same.

This is particularly true not only in Social Security, but also in the hospital insurance portion of Medicare, because there everybody gets the same benefits, and the tax that is paid is proportionate to earnings up to the base. So again, in the aggregate, it is a very progressive system.

Chairman LAFALCE. But we could look at the system of the United States as a whole—taxes and revenues—and say well, it is pretty progressive, but you have to look at taxes also to see whether they are progressive, linear, regressive, et cetera, and I am glad you agree with me that when you look at Social Security payroll tax, as a tax in and of itself, it is a very regressive tax.

Mr. MYERS. Then as to the question of who pays the tax, many economists say that the entire employer tax is really paid by the employee, because otherwise wages would be higher.

I think, as in many matters of economics, you can go around Robin Hood's barn and get any sort of answer you want, because no one really knows what would have happened if the employer didn't pay the Social Security tax. The employer might have had larger profits. The employer might have charged lower prices. The employer might have set up a pension plan of his or her own. It is just hard to say.

Shifting to my favorite topic of Social Security, the present financial status of both the Social Security System and the Hospital Insurance Program, they are fine. There is a very large fund that is being built up currently and at least up to the present time, everything is pretty good.

The Social Security Trust Funds at the end of 1989 were $162 billion, which was three times as large as they were estimated to be at that time, as estimated in 1983, when the reform legislation was enacted.

The fund ratio—that is, the ratio of the balance in the fund to the annual outgo—will be very close to 100 percent, at the end of this year, which many people, including myself, consider a quite adequate contingency reserve.

In the ensuing years, in the 1990's, the annual excesses of income over outgo, which some people label as surpluses, will increase from $70 billion in 1990 to as much as $200 billion in the year 2000.

As a result of this, according to the intermediate estimate, the fund will build up to $12 trillion in the year 2030, but then will plummet and become exhausted about 15 years later.

Looking at it another way, the fund will be about 5½ times the annual outgo in 2015 before plummeting to zero in 2045.

Many people say that the intent of this was to build a fund for the baby boomers. This is just not the case. I have gone into detail in my testimony why it is not true, even though it is so widely said. It was just a coincidence.

Chairman LAFALCE. I think it is worth making a statement or two about that.

Mr. MYERS. This building up of a large fund does coincide with the rise of the baby boomer retirement population, and then its decline.

The reason it occurred was that in 1983, the National Commission and the Congress very responsibly said that our first task is to be certain that the system gets through the 1980's, and we don't have another crisis, as we did shortly after the 1977 legislation.

I think that at this point it is absolutely safe to say that we got through the 1980's very well.

Also, Congress was responsible in saying let's look at the long-range situation—there is a deficit and let's remedy the situation. Congress did this in large part by raising the retirement age at which full benefits could be paid.

However, the taxes were front-end loaded. That is, the maximum tax rate was put into effect in 1990.

The result of all this was that on the average, the system was in actuarial balance over the 75 years, meaning that the benefits would just be financed. However, because of the front-end loading of the tax rate, it means that a big fund is first built up and then used up.

This, as I say, was only the result of this intention to have, on the average, the financing be adequate over the 75-year period. Of course, you all know the fallacy of averages, that you can drown in a lake that's 12 inches deep on the average if you happen to be in the part that's 10 feet deep.

So now you might say well, why were not the National Commission and Congress more responsible in 1983? Why didn't they make a thorough study and say just how is this going to develop year by year after the 1980's?

The answer is that there just wasn't enough time. It was such a crisis at that point, and to get a consensus from all the different political philosophies involved was a terrific task. So, Congress responsibly got the system sufficient financing to get through the 1980's and said that over the long range on the average, we will provide enough money.

What effect that will have year by year, they didn't go into. I think that, really, the view was that once we get through the 1980's, let's look at the situation. Let's fine tune the financing and do it in a reasonable manner.

One further thing about the situation is that it isn't as though the baby boom population is also going to cause a large hump in the cost of the program. The cost is going to be as high after the baby boomers depart from the scene as it was before, in terms of percentage of payroll.

So, it just doesn't really make sense in a pension plan or a Social Security System to build up a big fund and then dissipate it. It isn't as though the baby boomers were a closed group and you just

wanted to finance their benefits. There is the ongoing financing problem.

I believe that the building of a large fund is very dangerous and very undesirable for a number of reasons.

First of all, because of these large excesses of income over outgo each year in the next 20 years, it hides the real budget deficit in the general budget. Social security has had a balanced budget over the 50 years of its existence. It is the rest of the budget that is out of balance.

In the Gramm-Rudman targets, by counting the operations of Social Security even though Social Security is supposed to be out of the budget, but for the computation of the targets it is in, it seems to reduce these targets to zero eventually and really hides the deficit.

It is not really eliminating debt, because all these excesses of income over outgo are put into Government bonds. They are part of the national debt, and they will have to be paid off sometime.

Another danger of a large fund is that even if, as many people are talking about now, and I think desirably, Social Security is not counted for the Gramm-Rudman targets, and they are readjusting them, the availability of these large sums of money to be borrowed by the general treasury makes it very easy for the treasury to do it. It's not under the pressure of the marketplace and therefore there is less, financial discipline.

Still another danger of a big fund is, depending on how large it gets, that it could buy up all the national debt, depending of course what happens in other areas, too. That could, create difficulties in the financial markets.

Last of all, if there is a terrifically large fund built up, many beneficiaries will say, look at all that pile of money there. I'm only getting $600 a month. Give me a 10 or 20 percent increase, because the money is there to do it. I think that there could be unwise liberalizations of the program.

Chairman LAFALCE. Sure; there is all sorts of money there. Solve the notch problem, increase everybody's benefits, so they say.

Mr. MYERS. There are all sorts of people coming up with ideas. Recently, I heard somebody came up with the idea that the Railroad Retirement System is in trouble, so Social Security could spare a few billion dollars. You only need $30 billion for Railroad Retirement and what is $30 billion out of the trillions that Social Security has?

Chairman LAFALCE. Sure.

Mr. MYERS. So I just believe that a large fund is undesirable. Therefore, I very strongly support Senator Moynihan's proposal, which is not, as some people say, to reduce the tax rate. It is to reduce the tax rate now, but increase it later so as to try to match the tax income with the benefit outgo, maintain a fund of 1 year's balance.

Chairman LAFALCE. You want to go back to pay-as-you-go, Mr. Myers.

Mr. MYERS. Yes; I want to go back to pay-as-you-go. I think that is the soundest way in a national system like this. In private pension plans you can't do that, because the employer might go out of business.

Chairman LAFALCE. Good.

Mr. MYERS. So I believe very strongly in Senator Moynihan's proposal. Some people have criticized it and say look, suppose experience is bad in the 1990's? The pessimistic cost estimates shows that the system would go bankrupt in about 10 years under Senator Moynihan's proposal.

That isn't the real way that responsible, pay-as-you-go financing operates. If you have pay-as-you-go financing, you keep an eye on the operations of the system, and if the fund begins to drop in relative terms, you do something about it. You then raise taxes a little bit.

Any increases in taxes that would be necessary in times of bad economic conditions would not be any more than we are paying now.

So I think there is no danger of people not receiving their benefits if pay-as-you-go financing is adopted. I think that it's more responsible, and I think that really, in the long run, people would have more confidence in the system, because then there would be no longer all this clamor we heard about thieveries going on and moneys being embezzled out of the trust fund.

I think that people are now starting to lose confidence in the system, just as they did back in 1982 and 1983, when the system was definitely heading for financial disaster.

So I am afraid that I have more than used up my time, Mr. Chairman. I thank you very much.

[Mr. Myers' statement may be found in the appendix.]

Chairman LAFALCE. Thank you very much, Mr. Myers. I am sure we are going to have many questions for you at the conclusion of the panelists' presentation.

First we will hear from our next witnesses, and our very next will be Dr. Robert Shapiro, the vice president of the Progressive Policy Institute. Before joining the institute, Dr. Shapiro was a top economic adviser to the Dukakis/Bentsen campaign, and prior to that he was an associate editor of U.S. News and World Report.

From 1982 through 1986, he served in various capacities on the staff of Senator Moynihan, where I suspect some of his thoughts on Social Security and payroll taxes germinated.

Dr. Shapiro earned his doctorate at Harvard and holds a master's degree from the London School of Economics.

Dr. Shapiro, we are delighted to have you with us today and look forward to hearing your views on the issues before us.

TESTIMONY OF ROBERT SHAPIRO, VICE PRESIDENT, PROGRESSIVE POLICY INSTITUTE

Dr. SHAPIRO. It is a privilege to be here, Mr. Chairman and Representatives.

There are few legislative issues, I believe, more important than Senator Moynihan's proposal to cut payroll taxes, because at the center is the matter of how we finance the national Government.

The fact is, using the payroll tax to fund Government operations introduces systemic biases which affect how the economy distributes resources among businesses and how the economy distributes after tax wealth among individuals.

These biases arise from the fact that the burden the Social Security tax, the largest single tax on business activity and the second largest tax on individuals, is partly determined by factors related not to social insurance, but to how a firm's costs are distributed and how people earn their incomes.

Social security revenues are raised by taxing an increment of the market value of labor. Income generated by owning property or capital assets is exempt from tax as is labor value above the threshold, the cap.

By taxing only the factor of labor in production, the payroll tax focuses the financing burden on lines of businesses that have to devote a larger than average portion of their total cost to labor and on individuals who must depend more than the average on their own labor for income.

To the degree that a firm is in a line of business that depends on property or capital to generate income, its tax liability is reduced.

This slightly concentrates the tax burden, I believe, on businesses that are relatively less capital intensive which tend to be smaller businesses and younger businesses.

Similarly, a business's tax burden is limited to the degree that its labor costs happen to be concentrated on high value workers. This tends to shift the tax burden sectorally to industries such as retail, agriculture, food and health services that cannot efficiently employ a larger than average share of high wage labor.

Finally, when the payroll tax rises, as it has seven times in the last 10 years, a firm's relative burden is affected by its ability to absorb the cost increase. This, I believe, tends to favor businesses that can pass on to their customers all of any increase in these labor costs, especially firms and industries that are cartelized, protected or otherwise insulated from competition.

Businesses that are unable to pass through such increases must offset them by reducing other costs which I believe includes direct wages.

To sum up, the structure of the payroll tax tends to channel economic resources to older businesses, larger businesses, to enterprises that are less competitive, and to firms that are more dependent on highly skilled labor.

Among businesses that bear a relatively larger burden of the payroll tax, younger, smaller businesses operating a highly competitive market with a higher than average proportionate moderate and low wage workers, the structure of the payroll tax may tend to reduce the growth rate of wages.

There are corresponding biases in the payroll tax on individuals which tend to concentrate the burden on moderate and average income workers, tendencies well known to this committee.

Because of the cap and the flat rate, a worker earning a typical salary of $25,000 pays an effective individual payroll tax rate of 7.65 percent, while someone earning a salary of $100,000 pays an effective rate of 4.05 percent.

For a person earning $200,000, such as President Bush, the effective rate declines to 2.03 percent.

What justifications are there for these biases? On both the business side and the personal side, taxing only direct wage costs or

wage income at a flat rate offers a simple, efficient way of collecting revenues from a large and relatively homogeneous tax base.

To the degree that these revenues are used to provide workers with retirement income, it is reasonable to base retirement income on wage effort. This provides two immediate insights, I believe.

First, the cap on income subject to Social Security tax is unjustified both economically and in terms of fairness. It reduces the efficiency of the payroll tax system by arbitrarily restricting the tax base. It further makes the system more regressive by strongly favoring marginal wages earned by high income persons over those earned by moderate or average income persons.

Removing the cap, moreover, could ease the burden of payroll taxation——

Chairman LAFALCE. I somehow think that if we ever remove the cap, which we certainly should do, the upper income elite might see the inequity of the Social Security payroll tax as a means of financing Medicare and disability much more than they presently do.

Mr. SHAPIRO. You know politics better than I do, Mr. Chairman. I suspect you're right.

We could, however, apply the strategy of 1986 tax reform to the issue of the cap and ease the burden of payroll taxes on moderate and average income families without expanding the deficit. That is, raise the same amount of revenues by lowering the payroll tax rate while expanding the payroll tax base.

Based on data from the Social Security trustees' annual report, removing the cap would subject to Social Security taxes about $290 billion in covered wages and salaries in 1991.

By my estimate, by doing this, Congress could raise the same——

Chairman LAFALCE. Just a second, Dr. Shapiro. Give me that again.

Dr. SHAPIRO. There is $290 billion in wages and salaries which would be subject to Social Security tax in the absence of a cap. That is, if we repealed the cap in 1991.

Chairman LAFALCE. OK.

Dr. SHAPIRO. That doesn't include wages and salaries of people who are exempt from Social Security.

Chairman LAFALCE. Right.

Dr. SHAPIRO. By so doing, I estimate that Congress could raise the same revenues projected under current law for the trust funds, while cutting the total FICA tax rate from 7.65 percent to 7.25 percent.

Mr. LANCASTER. What would be the dollar yield?

Dr. SHAPIRO. Pardon me?

Mr. LANCASTER. What would be the dollar yield?

Dr. SHAPIRO. This is assuming the same level of revenue, the same revenues as currently projected under the current rate and the current cap. This is, as in tax reform, expanding the base subject to the tax by removing the cap and lowering the rate to produce the same amount of revenue.

Chairman LAFALCE. It would be a wash.

Dr. SHAPIRO. Right. This does not go to the issue of pay-as-you-go versus the current trust fund issue.

Chairman LAFALCE. Or to the issue of balancing the budget. We will get to that later.

Dr. SHAPIRO. Or to the issue of balancing the budget. What this does is remove the issue from the deficit debate in order to respond to the economic analysis of the impact of the cap on the efficiency of the system.

Chairman LAFALCE. If you could finish up in about a minute or two so I can make this vote and be back.

Dr. SHAPIRO. OK. By doing this, you would cut Social Security taxes for 120 million people, that is those earning less than $60,600 in wages and salaries. That is about 97 percent of all wage and salary workers.

An average worker earning $25,000 would get $100 in tax relief. Someone earning $54,000 would gain $217. On the other side, Social Security tax payments would go up for 3 million high salaried people—that is managers and professionals in the top 2 to 3 percent of wage and salary earners that now get to exempt much of their earnings from Social Security tax.

Chairman LAFALCE. Cut for 120 million Americans, increase for 3 million Americans, but end up where they both pay the exact same equal percentage?

Dr. SHAPIRO. Effective rate. That's right. The same effective rate.

Chairman LAFALCE. Good.

[Mr. Shapiro's statement may be found in the appendix.]

Chairman LAFALCE. We will recess for approximately 10 minutes, and we will resume with Dr. Steuerle.

[A brief recess was taken.]

Chairman LAFALCE. The committee will come to order. Our next witness will be Dr. Eugene Steuerle, presently a senior fellow at the Urban Institute.

Dr. Steuerle is the author of Economic Prospective, a weekly column in Tax Notes. Before joining the institute, he was Deputy Assistant Secretary of the Treasury for Tax Analysis during the latter part of the Reagan administration.

In that and former roles at Treasury, he played a large part in devising and implementing significant tax reform measures.

A prolific author, his books are used as texts at a number of universities and as valued resources by tax professionals around the country.

Prior to his Government service, he worked at the American Enterprise Institute and the Brookings Institution. He earned his Ph.D. from the University of Wisconsin and his undergraduate degree from the University of Dayton.

Dr. Steuerle, welcome back to the Small Business Committee.

TESTIMONY OF E. EUGENE STEUERLE, SENIOR FELLOW, THE URBAN INSTITUTE

Dr. STEUERLE. Thank you, Mr. Chairman. It is again a privilege to be here. As you requested, I will try to summarize my testimony, which has four basic themes. The first is that Social Security has been a remarkably successful program but it has many features that were designed for yesterday and not really for the needs of today and tomorrow.

Second, throughout most of the post-war era, this Nation financed its major changes in both expenditures and taxes through increased taxes on workers and on households with dependents.

Moderate to low income workers saw their tax burdens increase from almost nothing to over one-fifth of income. This era is now over and this hearing represents, in my view, merely the first of many hearings we are going to have on how to move into this new era.

Third, recent proposals to reduce Social Security tax rates should be considered analogous to proposals to increase the personal exemption in the early- to mid-1980's rather than to tax reductions in 1981.

In a former case, you may remember, it was possible to create a solid liberal-conservative coalition for reform and to create a fairer and more efficient system without increasing the deficit.

Fourth, some package of changes in Social Security is both desirable and to some extent inevitable. Not only is the system insolvent over the long run, but individuals with equal incomes pay very different taxes. The system discriminates against working women, the working elderly, and other groups.

Parts of the system are becoming less progressive as the basic principles behind its adoption are being disregarded, and more and more of total costs are simply subsidizing suppliers of medical care.

Let me comment very briefly on each of these points.

Any discussion of Social Security must start with one incontrovertible fact. The Social Security Program has been a remarkable success. Yet at the same time, the Social Security System we drive around in today is like a DeSoto.

Now, most of the political arguments on Social Security are between those who want to continue driving this DeSoto and those who want to abandon it in favor of what came before, the horse and buggy, but anyone who has examined the vehicle closely, knows that along with its extraordinary success, it still contains many components that represent the best technology of a bygone era, and not the knowledge of today.

The technology of this bygone era included the following. For several decades, the principal means by which the Government would finance shifts in functions would be to increase tax rates on workers, mainly workers at moderate income levels.

The evolution of Social Security has been so steady that it can be traced by a simple rule of thumb: 3 percentage points per decade. For almost half a century now, by the end of every decade, the combined Social Security tax rate has been increased by almost 3 percentage points, reaching 3 percent in 1950, 6 percent in 1960, a little over 9 percent in 1970, a little over 12 percent in 1980, and a little over 15 percent in 1990.

Increases in the Social Security tax rate, along with relative declines in the value of the personal exemption in the individual income tax, are the two most dominant tax increases of the entire post-war era.

Together they dwarf every other tax change. These increases on workers and households with dependents have been enacted in both Republican and Democratic administrations, with little fanfare, without conscious choice or recognition by many policymak-

ers, with only occasional publicity, and almost always without a vote during the year in which the tax increase actually took place.

These shifts occur both directly and indirectly. For instance, enactment of yet another saving incentive this year would likely increase the relative and perhaps the real tax burden on workers.

More directly, increases in Social Security tax rates during the 1980's alone—that is, increases over and above growth in tax base increases—have increased tax burdens by close to $80 billion annually.

Moderate income workers have been especially hard hit. The direct tax burden on a family that earns cash wages of about $20,000 has gone up from almost nothing in 1948 to about one-fifth of income today.

There are some who would draw an analogy between the recent proposal of Senator Moynihan and the deficit-increasing reductions proposed by President Reagan in 1981. I prefer a different analogy.

In the 1970's I began research on historical changes in the individual tax. One conclusion drawn from this research was that declines in the value of the personal exemption over time were paying for an enormous range of other regressive and inefficient changes, while increasing the taxes significantly on the poor and on households with dependents.

This research eventually was to lead one of the most important liberal-conservative coalitions of the decade of the 1980's, a coalition of those concerned with taxing the poor and those concerned with the taxation of the family. This coalition became crucial to the enactment of tax reform.

Now, initially there was great opposition to this coalition from the same group of people who today will tell you that budgetary deficit issues are so important that almost nothing else in the expenditure or tax system matters.

The formation of this coalition, nonetheless, was invaluable only a year later in the development of tax reform. As economic coordinator of that tax reform effort at Treasury, I was allowed to find ways to pay for this change in the personal exemption as part of a broader reform package.

In the context of other changes in taxes and expenditures, an increase in the personal exemption could be made part of a program of sound economic and fiscal policy.

I draw this analogy here because I believe it is important that the proposal to reduce Social Security tax rates be considered at the same stage or the same early stage of development.

To be successful, the Social Security tax rate reduction must be developed similarly. It should be part of a package that takes into account both short-run deficit issues and long-run Social Security and Medicare concerns.

Now, why do I think that a package of changes is possible, indeed almost unavoidable, in Social Security? As I mentioned earlier, we are driving around in a DeSoto. It is becoming more and more incongruous with its surroundings.

To give some examples, the system is extraordinarily inequitable. Two workers with the same amount of income often pay significantly different rates of Social Security tax.

Second, the system discriminates against women and minorities who are more likely to receive their compensation in the form of cash than in nontaxable fringe benefits.

Third, the system discriminates against secondary workers, again primarily women, by often giving them absolute zero benefits for their tax contributions.

Fourth, the system discriminates against those who work most of their adult years by giving them absolutely no benefits for several years of work.

Fifth, although the system as a whole is progressive, as pointed out by Mr. Myers, it is turning more regressive as the number of years in retirement increase. Payments to the younger among our elderly are being made by a population of workers who not only have to support their own children, but on average, have lower after tax incomes, lower wealth, and higher poverty rates than the younger elderly—not the entire elderly—the younger elderly they are supporting.

Sixth, the Social Security System is becoming less progressive among beneficiaries. This issue arose in a draft study that I completed for the Treasury Department entitled, "Financing Health Care for Tomorrow: A Report to the President and to the Congress on Long-Term Care and Catastrophic Health Needs."

We could easily provide long-term health care insurance if we were willing to follow the principles on which Social Security was established.

Seventh, the choices of the elderly are becoming more and more constricted. For example, the Federal Government tells them they must buy acute medical insurance when they may have a greater need for chronic or long-term care insurance.

Eighth, elderly individuals who work effectively pay significantly higher tax rates than do many other elderly individuals with equal incomes.

Ninth, an increasing portion of Social Security taxes and income taxes, $85 billion by one measure, are doing nothing more than subsidizing suppliers of medical care without increasing benefits to the elderly.

Finally, as every single policymaker in Congress and the executive branch knows, the combined Social Security and Medicare system as a whole is insolvent. By waiting for the appearance of a crisis before anything is done, we display the same mentality that has been shown in the savings and loan and the housing and urban development situations.

Let me add that important improvements in the fairness and efficiency of the Social Security tax and benefit structure can be accomplished easily without any change in old age benefits currently being provided to retirees and without any decrease in the overall progressivity of the system.

In summary, Social Security tax rate reduction is a logical consequence of moving away from an era where most Federal policy changes are required to be financed by workers and those who care for dependents, that is by those who accept responsibilities in society.

Social security rate reduction should be part of a package that takes into account deficit concerns in the short run and the long-

term structure of Social Security. Rate reduction is a reasonable and essential component of any broad-based attempt to come to grips with some of the clearly regressive, inefficient, and inequitable aspects of the combined Social Security tax and benefit structure. Thank you, Mr. Chairman.

[Mr. Steuerle's statement may be found in the appendix.]

Chairman LAFALCE. Excellent; thank you very much, Dr. Steuerle. All of you have given excellent presentations, and of course, I am just filled with questions. It is going to be interesting how two such outstanding individuals as Mr. Myers and Dr. Steuerle can be making——

Dr. STEUERLE. Mr. Chairman, I think we have one more witness.

Chairman LAFALCE. Yes; I know we have another one. Are you going to be able to resolve the conflict with Mr. Myers saying that Social Security/Medicare system is in fine shape and Dr. Steuerle saying it is already insolvent? But we'll get to that.

We have one more outstanding witness, and that is going to be Mr. Stephen Entin, a resident scholar at the Institute for Research on the Economics of Taxation.

Like Dr. Steuerle, Mr. Entin was a Deputy Assistant Secretary of the Treasury during the Reagan administration, in this case for economic policy.

Among many other duties, he represented the Department in the preparation of annual reports from the Social Security trustees and conducted research into the long-run outlook for the Social Security System.

Before joining the Treasury, he was a staff economist for the Joint Economic Committee.

He is a Dartmouth graduate and received post-graduate training in economics at the University of Chicago.

Mr. Entin, thank you for joining us.

TESTIMONY OF STEPHEN J. ENTIN, RESIDENT SCHOLAR, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. ENTIN. Mr. Chairman, thank you very much for the invitation to appear. I have been interested in Social Security since my Joint Economic Committee days and got quite an education in working with the actuaries over the years while I was at Treasury. It is a fascinating subject.

The statement I am making today is in support of proposals to reduce the payroll tax rate, specifically that part of the payroll tax rate that involves the Old Age and Survivors Insurance and Disability Insurance System.

Those rates should be brought down to levels more nearly equal to the current outlays for retirement and disability benefits. If it is done without unnecessary increases in other taxes, such a rollback could increase employment and GNP substantially over the coming decade.

My statement focuses on the economic benefits of payroll tax rollback, with particularly attention to the proposals submitted by Senator Daniel P. Moynihan and Senator Robert W. Kasten, Jr.

The committee has asked about the regressivity of the payroll tax and about charges that Social Security funds have been misused to fund other parts of the budget.

I think that these concerns are relatively minor or inaccurate and they are not the real reasons why the payroll tax should be cut. The payroll tax should be regarded either as part of the Social Security System which is, overall, progressive, with a heavy tilt in benefits to lower income recipients.

The Social Security tax as part——

Chairman LAFALCE. You are considering the whole system, not the tax alone.

Mr. ENTIN. If you are going to consider the tax, it should be considered as part of the total tax system.

Chairman LAFALCE. That's right.

Mr. ENTIN. I don't believe that you should take a part of either system and regard it as necessary to make each part of each program progressive. I think if the total impact is progressive, that is the way to go about it.

Chairman LAFALCE. So you mean you can't consider whether the gasoline tax is regressive. You can't consider whether an excise tax is regressive. You can't consider whether a liquor tax is regressive. You can't consider whether the Social Security tax is regressive. You just have to look at the totality of taxes.

Mr. ENTIN. I think there are better ways of increasing progressivity in the tax code than trying to do something with the payroll tax. I think if you want to——

Chairman LAFALCE. That's a separate question.

Mr. ENTIN. Suppose you wish to increase the gasoline tax——

Chairman LAFALCE. That's a separate question. The question is——

Mr. ENTIN. You might want to offset it with a change in the——

Chairman LAFALCE. The question is whether or not it is appropriate to look at an individual tax, and term an individual tax either regressive or progressive or somewhere in between.

Mr. ENTIN. Not when you've tied them so closely to some program, no; I don't think it is proper.

Now, I think there is a good argument, other than these, for cutting the payroll tax and I want to endorse such efforts, although I may disagree about regressivity being the prime motive.

Economic gains are the real reason to cut the payroll tax. The payroll tax is an excise tax on labor. It costs jobs. A tax rate cut of about 2 percent of payroll would save about 700,000 to 1.1 million jobs over 10 years and would raise GNP by about one-half to six-tenths percent.

This would be about $30 billion to $40 billion per year in terms of today's economy. It would add eventually about $130 billion to $210 billion to the capital stock as the greater availability and affordability of labor encouraged more investment.

The economic damage from the payroll tax can only be reduced by cutting the tax rate, not by playing with budget definitions. Social Security should be included in the deficit computation and in the Gramm-Rudman-Hollings deficit targets.

There is an excellent piece on the rationale behind this available from the Congressional Budget Office, entitled, "The Economic and

Budget Outlook: Fiscal Years 1991 through 1995," which has recently been released.

As the Congressional Budget Office has pointed out in that report, the flow of dollars into and out of the trust funds affects the total Government deficit. It must be financed.

Simply stated, the Government has a deficit because it spends more money than it takes in. Any policy change that adds to revenues or reduces spending trims the deficit and visa versa. This truth applies to Trust Fund Programs just as it applies to the remainder of the budget.

Now, the administration has suggested that we keep the payroll tax rates where they are and eventually, as we bring the rest of the budget into balance, start running large budget surpluses.

I feel that it is better to balance the total budget than to run large surpluses. Growth is best achieved by reducing tax rates on labor and capital, lowering their costs and encouraging more utilization of labor and the higher capital stock.

If the payroll tax rate is reduced, it should be cut cleanly and simply. It should not be entangled in complex tax credits, nor limited to the lower portion of covered income or the economic gains would be reduced.

We have heard this morning proposals to lift the cap on the payroll tax. I think you will find that when all labor cost adjustments have been made in the market, this would be harmful to small business. The workers would capture the tax reduction. Obviously that would be the intent of it, but the tax increase on the small businessman who may well be over the cap would certainly discourage small business activity.

Furthermore, I think you will find over time, unless you tell the person whose cap you have lifted, that the added tax on the added income will not in any way increase his benefits, that you would lose about 80 percent of the revenue in the form of higher benefits. You would lose some more on the income tax side as the higher tax became partially tax deductible under the income tax. As small businessmen may cut back work effort with the higher tax burden, you would lose further under the income tax and eventually come out with a net loss to the budget.

Computations that show this are really quite straight forward and I would be pleased to go into them later.

Payroll tax cuts should not be offset by increases in other taxes or the economic gains, again, would be lost. The Gramm-Rudman deficit targets should be changed to permit the rate cuts.

Nor is there any need to wait until the total budget is in surplus after 1993, assuming we stick with the Gramm-Rudman targets. This would unnecessarily delay the economic gains.

The added debt built up under the Moynihan or the Kasten proposals, nearer $300 billion under Moynihan, nearer to $225 billion to $250 billion under Kasten, would generate only a modest increase in annual debt service, between $15 billion and $20 billion a year, which in terms of the economy in 1995 or 1997 or the year 2000 would be really quite modest.

Future tax increases, I feel, should not be included in the bill. The tax rate increases scheduled for 2012 and beyond in the Moynihan bill to cover rising OASDI benefits would reduce employment

at that time by between 2 and 3 million jobs below current low levels. The increases may be made unnecessary by increases in fertility, immigration, or productivity, or by benefit changes through raising the retirement age or other means.

Before we pass judgment on what the future workers and retirees want to do in those out-years, it would be wise to consult with them and see what they want in the way of retirement benefits versus health benefits, or to see what they want in the way of retirement benefit increases versus tax increases. Until we are able to make that inquiry I think it is simply too early to act.

I have included tables which show where benefits are headed under the current benefit formula. They roughly triple in real value per capita and the tax rate that would be required to pay those benefits, of course, will have to be a higher one than exists today because of the demographic trends.

I think we need to sort out that issue before we take action at this time. Some have expressed concern that a payroll tax cut would threaten future benefit payments. This is not accurate. OASDI will be running substantial surpluses for about 25 years. It would not need the spending authority in the trust funds in that time period in any event.

Furthermore, the trust funds do not constitute money with which to pay future benefits. They are merely a promise that funds will be found in the future to pay benefits at that time. Regardless of the status of the trust funds, Congress will have to address the financing of the system as the baby boomers retire and as growing health care demands and soaring retirement benefits per capita compete for payroll tax revenues which future workers may resist paying.

The reason the system will have to be reviewed when the trust funds are used to pay benefits is that the large additional borrowing by the Treasury in the credit markets to redeem the bonds that are in the trust funds will at that time have a heavy economic impact on the economy which the budgetmakers in Congress will want to consider. Perhaps they will want to perhaps change the rest of the budget to be in surplus while the Social Security is in deficit, or they may wish to make a tax adjustment at that time to avoid drawing down the trust funds.

I don't feel you should regard the trust fund reserve level as a barrier to the rate reductions. Mr. Myers has made up a long list of other reasons why the trust funds should not be allowed to build, and I am in substantial agreement with him. I won't repeat those at this time.

In short, sir, I hope you will find a way to reduce the payroll tax rate in spite of the current budget climate in a clean and simple fashion. It would be very good for the economy if you did.

[Mr. Entin's statement may be found in the appendix.]

Chairman LAFALCE. Thank you very, very much, gentlemen. I think all of your presentations have been excellent.

Before we begin the questioning, though, I think I should ask the panelists if they have any comments they feel they would like to make about comments other panelists have made.

It seemed to me that Dr. Shapiro was disagreeing strongly in his original comments on some of the points that Mr. Entin made and I wonder if we could join issue there.

It seemed to me that Dr. Steuerle and Mr. Myers were disagreeing about the present solvency of the Social Security System and I wonder if we could join issue there before you begin answering our questions.

How about first joining issue between Dr. Shapiro and Mr. Entin? Dr. Shapiro.

Dr. SHAPIRO. Even though I would probably support a general payroll tax cut, on two points I certainly disagree with Mr. Entin. I think it is very clear that aggregate progressivity is not the only question. It is very easy to illustrate. The problem of course is that people don't live in the aggregate, they live in the individual and people who have to pay the individual tax bear that burden regardless of their position with reference to nine other income deciles, so that, for example, the fact that a marginal dollar earned by someone with a previous income of $300,000 is taxed at the same rate as a benefit dollar received by an AFDC recipient, which is to say at a rate of zero, does not make the system progressive for someone earning $20,000 whose marginal dollar is taxed at a rate of 15.35 percent.

Chairman LAFALCE. I had the same problem with those outrageously irresponsible Kemp-Roth tax proposals that were eventually enacted into law in 1981. The euphemism was, "across the board tax cuts, treat everybody equally."

But if you are only talking about the income tax code, then a 10 percent cut for a guy making $20,000 and a 10 percent cut for a guy making $220,000, that is one thing. But then no cuts in the payroll tax—indeed increases—and the guy making $20,000 is paying the same percentage as the guy making $220,000 but only up to a certain dollar amount.

In that year—I forgot what the cap was, about $30,000—it wasn't across the board. You had to consider taxes in the aggregate at that time, and that's when they didn't want to consider taxes in the aggregate. They only wanted to consider them discretely, but not in the aggregate.

Dr. SHAPIRO. I agree. We certainly made significant progress in progressivity in the 1980's in one area, and one area only, and that is in exempting poor workers from income tax.

Chairman LAFALCE. The 1986 tax code really went a long way in increasing the personal exemption which Dr. Steuerle talked about so much, and the standard deduction. Those were the big enchiladas of the 1986 Tax Reform Act, along with the earned income tax credit.

Dr. SHAPIRO. This last reference to the issue of progressivity arises in the context of the current use of the surplus. I would argue that the payroll tax cannot be justified as a way of raising revenue for non-Social Security spending precisely because it decouples the regressive tax structure from the progressive benefit structure.

For taxpayers, there simply is no logical or historical basis——

Chairman LAFALCE. OK, if you want to look at the aggregate system, the regressive tax and the progressive system and say well,

overall it is progressive because the progressivity of the benefits outweighs the regressivity of the tax, you can only do that up until the point that there is a match.

To the point that there is a surplus——

Dr. SHAPIRO. Exactly.

Chairman LAFALCE. Then the regressivity of the tax demands redress.

Dr. SHAPIRO. That's right, and the result is that those earning a middle class income or less, and only those without capital or property assets, are forced to bear the entire burden of paying for a portion of non-Social Security spending.

For business, there is no economic rationale I know for funding a portion of the national Government through a tax that favors companies that are large over those that are small, firms that are old over firms that are young.

Chairman LAFALCE. Mr. Entin says that you increase or eliminate the cap, it penalizes the little guy, not the big guy. I have a tough time seeing that.

Dr. SHAPIRO. You don't penalize anyone. You subject to the same tax rate those earning high wage incomes as those earning average wage income.

Chairman LAFALCE. Across the board treatment.

Dr. SHAPIRO. Yes; across the board treatment. Mr. Entin seemed to want to have it both ways. On the one hand, he said that this would discourage high wage, small businessmen because their taxes would go up. At the same time, he said that most of the benefit would be lost from increased benefits, presumably to those same people.

He wants to have it both ways. I don't want to have it either way. It is up to Congress to determine the future relationship between the payroll tax and benefits. It has been changed in the past, it can be changed in the future for those at high income levels.

Chairman LAFALCE. OK, Mr. Entin, Dr. Shapiro and I have disagreed with you. You deserve a chance to present your case.

Mr. ENTIN. I suggested that the small businessman might be hurt, not the little man. Small doesn't mean little. I mean small in the sense that small business owner might be injured by the lifting of the cap.

Chairman LAFALCE. The wealthy small businessman.

Mr. ENTIN. The small businessmen generally do earn more than their workers. I can't help that, but if the small business community is to be heard from, I think they might object to that.

Chairman LAFALCE. We're talking about those making above, what is it, $50,300, $51,300.

Mr. ENTIN. $51,300.

Chairman LAFALCE. OK, and having them taxed at the same rate as those below $51,300.

Mr. ENTIN. I think the semantics of the taxation——

Chairman LAFALCE. Is there anything unfair about taxing those who make $55,000 the same rate as those making below $50,000?

Mr. ENTIN. No; I think——

Chairman LAFALCE. Anything unfair about taxing those making $150,000 at the same rate as those making below $50,000?

Mr. ENTIN. If you count all the taxes. I would like to know what the total is before I answer the question.

Chairman LAFALCE. I'm just talking about the payroll tax right now.

Mr. ENTIN. That's what you can't do because one person is in the 33 percent tax bracket——

Chairman LAFALCE. I think we can. I'm willing to do it. I can do it. Dr. Shapiro is willing to do it.

Mr. ENTIN. Well, then——

Chairman LAFALCE. I think we can do it. Whether we should do it is something else. I think we should, you think we shouldn't, but we surely can, right?

Mr. ENTIN. If you raise the cap on someone whose income taxes are in the 15 percent bracket, which they probably would not be of course, then you would get a different result than if you raise them on someone whose income is in the 33 percent bracket.

The economic consequences of a tax can't be disregarded. Progressivity cannot be the only thing you look at.

If you raise a tax where it is already high in the aggregate, such as for someone who is in the 33 percent bracket but is not paying the 15 percent payroll tax, and you put that tax on and you take account of the tax deductibility of half of it, you've got roughly a 12 percent add-on to the 33, plus perhaps 5 percent at the State level.

Chairman LAFALCE. This is interesting, but didn't we reduce the income tax from 70 percent to 28 percent?

Mr. ENTIN. Yes; you did and one of the results was a fairly sharp increase in the amount of reported income and work effort by the people in those brackets, such that they ended up paying a higher share of the income tax than they had before.

That theoretical outcome of the change in the after tax return to work effort and capital income effort did result in practice in increased reported income in those brackets, and they did pay a higher share of the income tax liability.

Now, the flaw in the 1980's perhaps was that not enough attention was paid to the relationship between payroll taxes and income taxes. If you look only at the income tax, progressivity was increased in 1981 and again in 1986. Even in 1981, the percentage reduction in the rates was slightly higher on the lower end of the scale than the upper end of the scale.

Chairman LAFALCE. Yes.

Mr. ENTIN. Progressivity, remember, is a proportionate or relative thing.

Chairman LAFALCE. For the record, let me state that there were many of us, especially—because my district was contiguous to Congressman Jack Kemp's—myself who were proclaiming that you cannot consider simply the income tax alone. You must also consider the payroll tax.

Mr. ENTIN. Yes, sir, and if you recall——

Chairman LAFALCE. That unfortunately, by passing the 1981 income tax cuts, you precluded the option of meaningfully addressing the gross inequity of the Social Security payroll tax.

Mr. ENTIN. In the early 1980's, sir, with the 1985 bankruptcy of the system staring us in the face and the need to appoint a national commission to find some way to salvage the system, I don't think

anyone in 1981 would have proposed a payroll tax rate reduction, certainly not without drastic changes in the system that no one wanted to see, particularly with so many retirees dependent on it.

I think you have here a situation where you have picked a particular tax——

Chairman LAFALCE. Not without an offsetting income tax.

Mr. ENTIN. You have picked a particular tax to fund a particular program, and to some extent we have to live with that. That does not mean that the tax does not have an effect on labor and capital. The income tax plus the payroll tax plus the corporate tax plus the 1986 act tax changes all have to be considered as to their economic impact as well as the statutory relationships between one program's income and one program's outlays.

I think that is what is missing, because there is not enough overview of how these taxes interact to affect the economy and then feed back on Federal revenues and employment.

Chairman LAFALCE. Dr. Steuerle and Mr. Myers, do you wish to join issue regarding the solvency of the system itself? It seemed to me you said different things. Did you say different things, or did I misinterpret you?

Dr. STEUERLE. I'm not sure that we actually disagree. I consider myself in part a fan of Mr. Myers. I hope that the feeling is at least somewhat reciprocal. I am not sure that we disagree on most Social Security issues.

The Medicare part of the system is clearly insolvent, once we go past the turn of the century. I always have a problem with separating the Social Security from the Medicare part of the system, in part because I think the separation leads us to make some very bad decisions to pay the elderly more and more in in-kind benefits when maybe we should be paying them more in cash and allowing them to make more decisions.

The long-term Social Security System is becomes slightly more insolvent every time we add another year on to the system. If you read the actuarial reports closely, what they indicate is that every time we add on another 75th year, we move a little more and more into long-run imbalance.

Now, I did not mean by insolvency that we couldn't pay benefits over the next few years, and I think that may be the source of——

Chairman LAFALCE. You are saying around the turn of the century, you think.

Mr. Steuerle. We know we have a Medicare problem to deal with and we know we have a very long-term cash problem as well.

I would not separate the two. I think we ought to treat the system as a whole.

Chairman LAFALCE. Mr. Myers would suggest, I think, that we deal with this problem by adopting a pay-as-you-go system. I will let him speak for himself.

Mr. MYERS. Thank you, Mr. Chairman. I don't think that I was in such great disagreement with Dr. Steuerle on this. Perhaps I didn't make myself clear about the hospital insurance portion of Medicare.

What I said is that at the moment, from a cash flow standpoint, it is in very good shape. It has a very sizable fund built up, but I

would certainly agree that in 10 to 15 years it is going to have real problems.

As far as the cash benefits program is concerned, under the Moynihan bill or even under present law, but particularly under the Moynihan bill, the system is solvent over the long-range because the tax rates are designed to match the benefit outgo. Under present law, there is a small long-range deficiency that gets a little worse each year because of a technical matter.

I think the cash benefits program can be said to be in good shape over the long run. The Medicare Program definitely is not.

I don't like combining the two programs. I think we will always need a Cash Benefits Program. I don't think that we will necessarily always need a Medicare Program. I can envision some scenarios where there will not be any Medicare Program 10 years from now.

Chairman LAFALCE. Under some type of National Health Insurance Program.

Mr. MYERS. Yes.

Chairman LAFALCE. Sure.

Mr. MYERS. So I think they should be looked at separately. Of course, I think that one difficulty perhaps between the other panelists and me is that I consider the Social Security and Medicare Programs as separate Social Insurance Programs that should be considered only within themselves. I don't consider the taxes to be the same order of taxes as general income taxes.

In other words, I want to look at the system just within itself and let the rest of the budget take care of itself, some way or other. That's not my problem.

Chairman LAFALCE. Sure; but that is our problem.

Mr. MYERS. I agree that it's a very great problem and one that I am very much personally concerned about, but I think it is perfectly proper to consider the Social Security System as being, hopefully, a self-supporting independent institution.

Chairman LAFALCE. Of course, when you started out, when the Congress passed the legislation, Social Security was basically just a retirement system. It didn't have Medicare and disability benefits as part of it, is that correct?

Mr. MYERS. That's correct.

Chairman LAFALCE. So the payroll tax was only intended to finance the retirement benefits, not health coverage and not disability coverage.

So it is an historical development that we witness where the programs were added to the system without really examining closely the propriety of continuing to use the payroll tax as the sole or primary means of financing these added and different—decidedly different—benefits, is that correct?

Mr. MYERS. With all due deference, Mr. Chairman, I would say that the survivor benefits and the disability benefits are retirement benefits.

Chairman LAFALCE. The survivor benefits, OK, and what about Medicare?

Mr. MYERS. I would agree that Medicare benefits are a different type of thing.

Chairman LAFALCE. You can make a much stronger argument for disability than you can for Medicare and survivor benefits, I am willing to concede.

Mr. MYERS. Disability benefits are really just early retirement benefits. It's just that the person reached old age much sooner.

Chairman LAFALCE. I would, in a crunch, consider carefully conceding that one too. But Medicare, I think, is where the big dollars come in and I feel strongly that we should use some other means of financing Medicare and a much more progressive means.

That would mean, therefore, we could reduce the Social Security payroll tax further.

Mr. MYERS. Mr. Chairman, as you are well aware, one part of Medicare is financed out of general revenue. Seventy-five percent of part B of Medicare is financed out of general revenues so the total Medicare Program is financed by a rather heterogeneous method of financing—some payroll taxes, some individual premiums, and some general revenues.

Dr. STEUERLE. Mr. Chairman——

Chairman LAFALCE. Yes; I appreciate that fact. But the portion financed by payroll tax is still appreciable and since the payroll tax as a tax is regressive and a tax on labor, and a tax on small business, I mean, I really think that we should be giving much more attention as part of this total debate to financing programs other than retirement benefits from general revenues rather than the payroll tax.

Now, which ones we could argue about, I will say all other than retirement, I've got a fall-back position, but I can't fall back beyond the totality of Medicare being paid by something other than the payroll tax. That's my own personal opinion, but whether we would ever be able to get consensus from the Congress on that is something else.

Dr. Steuerle, you wanted to make a comment.

Dr. STEUERLE. I was going to say that every time we make any decision that has budgetary consequences, we are really making two decisions—just as we know when we finance an expenditure, eventually we have to pay for it, either through increased taxes——

Chairman LAFALCE. Sure.

Dr. STEUERLE. Or through floating of more bonds, borrowing more, and paying more interest. But every decision has a balance sheet aspect. I think the same thing has to be said about cutting the payroll tax even in the short run. Even if we cut taxes in a way that keeps Social Security solvent by having large tax increases in the long run——

Chairman LAFALCE. You've got a budget deficit.

Dr. STEUERLE. Exactly; even in the short run, there is a balance sheet side to tax reduction. All of us on the panel would agree that just——

Chairman LAFALCE. Which is why I support the Moynihan proposal, but I think it's incomplete. I think it must be coupled with another proposal simultaneously to offset those revenues. But I don't go along with the thought that, "oh well, the debt service would only be increased by $15–$20 billion a year." That's more of the same.

Dr. STEUERLE. Since you were seeking some disagreement between Mr. Myers and myself, let me add why I think in the long run we might end up in the same place politically. I am not sure we——

Chairman LAFALCE. I'm about to call on you, Mr. Flake, if you would like to ask questions. OK, go ahead.

Dr. STEUERLE. While politically we might end up in the same place, I am not sure that I would get there quite the same way. Mr. Myers is a little more sympathetic to going to a pay-as-you-go system and letting the tax rate increase as we move out into the 21st century.

I think that's really not an optimal design in the long run. We know already that we are going to have two of our children supporting every one of us in retirement. I think that is far too much of a burden. The tax rates we would be imposing on them is far too high.

Now, I think if you put Mr. Myers and I in a back room, he would say that that just means we've got to chase the long-term structure of Social Security down the road, but he still wants to achieve pay-as-you-go in the short run.

I am less sympathetic to creating a system that I don't think is right in the long run—that has too high a tax rate. I would like to get the system right in the beginning: if we want to go to pay-as-you-go now, we should deal with the benefit structure in the long run and decide what type of tax rates we want to impose on our children.

Chairman LAFALCE. Good; I have a lot more questions but first, do you have any questions, Mr. Poshard?

Mr. POSHARD. I have no questions, Mr. Chairman.

Chairman LAFALCE. OK. Let me go to this. You heard what I had to say about Moynihan's proposal. I support it, but I can only support it as part of a larger package, one that would also offset the revenues with some other type of a tax increase, so you have a tax cut and a tax increase. You need the two.

But another proposal has been floated recently which I think is a bold proposal, a courageous proposal, a necessary proposal, and that is the one that Congressman Rostenkowski came out with Sunday in the Washington Post.

This is a plan to balance the budget by doing a lot of things, balance it meaningfully rather than all the smoke and mirrors we have been seeing for the past half dozen years or so.

You know what it is. Basically it is a freeze on most spending including Social Security benefits for 1 year. It is a considerable reduction in the defense budget, devoting the entirety of the savings to deficit reduction, saying that if you want additional money for Nicaragua, raise the taxes to do it, or for any place else.

Then it also proposes increasing certain taxes, eliminating the bubble, suspending the adjustment of the brackets for inflation and increasing the gasoline tax, et cetera. So that nobody accuses me of equivocating, I have written to Danny saying, "put me on as an original cosponsor if you ever introduce the bill."

I think his proposal could be improved significantly, but everybody says that. They could use that as an easy out. I also say if we have to have a vote on that bill as is, I will vote yes.

On the other hand, there is a little bit of a conflict between doing that and cutting the payroll tax and dealing with the inequity of the payroll tax system.

Is there any way that we can reconcile these approaches? You are very interested in this, Dr. Steuerle. I mean, this is the gravamen of your entire testimony, it seems to me, that you've got to be able to do all of these things and you think it's possible.

You, in your 1986 tax reform bill, didn't do all of these things. You addressed everything in your bill—progressivity, fairness, equity, doing something about personal exemptions—but the one thing you didn't do, and you were under Presidential mandate, is increase revenues. You had to have a bill that was revenue neutral. That was one of the problems. Some people said that was the beauty of it.

How do we reconcile doing something about the inequity of the Social Security payroll tax and cutting the payroll tax, doing something about the tax on labor while at the same time proceeding with something such as the Rostenkowski proposal that will, over a 5-year period, balance the budget?

This is not Mr. Myers' concern, but it is my concern. Anybody want to comment on it?

Mr. MYERS. I would, Mr. Chairman.

Chairman LAFALCE. Sure.

Mr. MYERS. I think that Chairman Rostenkowski has done a fine thing, just as did Senator Moynihan, to get the debate started. However, there are two points on which I surely don't agree with in his proposal.

Chairman LAFALCE. I hope every committee will have hearings such as this to help encourage debate on these central cutting issues.

Mr. MYERS. Primarily I would like to see the budget balanced, leaving Social Security out of it. This is in line with my general belief that Social Security is a separate, self-contained, self-financed social insurance system that has had a balanced budget over 50 years, and will continue to have one.

Chairman LAFALCE. Sure; but when you take Social Security out of it, and you increase your budget deficit by from $50 to $70 billion in 1 year, you just can't ignore that fact. You have to say well, what are you going to do about it?

Mr. MYERS. I realize it can't all be done at once, but that reality should be taken into account and what I think is the real budget deficit should be looked at. If you do that, then there is no need to try to apparently save money by reducing, by eliminating the Social Security. The money is there in the system to finance it, and it should be paid.

Chairman LAFALCE. Dr. Shapiro.

Dr. SHAPIRO. I agree with Bob Myers, as almost always, on this. It seems to me that each issue clarifies the other. That is, if we change the sequence of events and ask ourselves would Congress pass a tax to reduce the overall deficit by $50 billion this year, and $60 billion next year, and $70 billion the year after, which said that the tax would cover only wage income, that the tax would stop at $54,000, and that the tax would exempt income earned from capital assets and property.

I think it is clear that as a deficit reduction measure, Congress would not support a tax which had the regressive impact of the Social Security payroll tax.

In effect, that's what we do, of course, and to bring the two issues together, I think clarifies what from my perspective and the perspective of a lot of people, is a fundamentally unjust arrangement.

Chairman LAFALCE. You see, we've never ever before brought these issues together.

Dr. SHAPIRO. Right.

Chairman LAFALCE. We've always talked in different worlds.

Dr. SHAPIRO. Yes; but they belong together.

Chairman LAFALCE. Yes.

Dr. SHAPIRO. Precisely because of——

Chairman LAFALCE. Even Senator Moynihan hasn't brought them together because just talking about the tax cut without talking about the need of solving the budget deficit, you've got to bring them together.

Dr. SHAPIRO. Nor would we have brought them together had we not had the convergence of a Social Security surplus and a large budget deficit. It is those circumstances which bring them together, and which I think force people to act.

I think, as an economist, that a zero budget deficit may not be the economically optimal goal. I would argue, a lot of people would argue, that this economy would benefit from a deficit in the range of $50 to $80 billion, a range which would keep the real value of the debt about equal and not reduce it, so as to avoid a fiscal drag on the economy.

But certainly, it is a hard problem to create a consensus for any additional taxes or spending cuts, and the fact that justice or fairness requires that that task be even larger, in order to address the inequities of the Social Security tax, does not in any way change the inequities of the Social Security tax.

Chairman LAFALCE. What if we were to remove the cap—right now it's $51,300 and whatever that amount is that we would raise, devote that total amount to cutting the Social Security payroll tax?

Dr. SHAPIRO. That is what I was proposing.

Chairman LAFALCE. Precisely; that's one thing. That does nothing about reducing the budget deficit.

Dr. SHAPIRO. That does not touch the deficit.

Chairman LAFALCE. It doesn't do anything. Then what about beyond that, if we say that let's forget about disability and survivor benefits, but just Medicare, if we fund Medicare entirely—not 75 percent—but entirely from payroll taxes, or at least as much of it as we can by taxing through the income tax, a greater portion of Social Security benefits?

We already tax Social Security benefits. We tax 50 percent over a certain dollar amount. What if we simply taxed 85 percent of the benefits and, assuming the progressivity of the income tax, say without any threshold, or a lower threshold or something like that.

Now, that would be a way of again cutting the payroll tax further so you would have a wash there.

Dr. SHAPIRO. I think the other thing to keep in mind, and something that Dr. Steuerle knows better than anyone else in this room, is that if you are going to——

Chairman LAFALCE. That would leave you free to do Rostenkowski too, because none of those things would be impacted, or you wouldn't preclude any of the things Rostenkowski was talking about.

Dr. SHAPIRO. Yes; and Congressman Rostenkowski's proposal points to a fundamental fact, which is, that you can raise large amounts of revenue only from a broad base——

Chairman LAFALCE. Yes.

Dr. SHAPIRO. There are really only three broad bases in our economy. One is an income base, another is a consumption base, and the third is an energy base. Proposals for significant deficit reduction inevitably come down to some form of energy tax, income tax change, or consumption tax precisely as a matter of mathematics. They are the only sufficiently broad bases.

Chairman LAFALCE. OK, but Dr. Steuerle and Mr. Entin and we've heard from Dr. Shapiro, what would you think of cutting the payroll tax to the extent that we have revenues to pay for it by removing the $51,300 cap? Dr. Steuerle?

Dr. STEUERLE. Could I go back, because we are mixing several questions here.

Chairman LAFALCE. Yes.

Dr. STEUERLE. I very much applaud the effort made by Mr. Rostenkowski, as do you. I think it is time we got off the dime on this deficit issue. One reason we don't tackle issues like the Social Security—not just the issue raised by Senator Moynihan but some of the other issues I've raised, some of the ones Mr. Entin has raised—is that we use the deficit as an excuse not to act.

Chairman LAFALCE. Sure.

Dr. STEUERLE. We talked about this in a previous hearing. While I really applaud the idea of combining Social Security rate reduction and deficit reduction, as a political matter—and you know more about this than I do—it is probably very difficult to sell to the public a package that combines the two. One package essentially says look, all of us are going to pay some cost to get rid of this deficit. We are going to reduce expenditures. We are going to increase taxes.

It is probably very hard in that type of package to combine it—however logical it may be—with another package that ends up reducing taxes for one group.

As a practical matter, what we did in tax reform was similar. Even though we did cut here and there, we told everybody look, we are going after all your tax breaks.

With deficit reductions, we are saying, look we are going to cut the Nation's long-term debt. That's the benefit you're getting and the way we are going to achieve it is to ask everybody to pay some short-term price.

So I think it's difficult to combine a Social Security rate reduction with a deficit-reduction package. Even though personally I wouldn't mind combining the two. I think it would be very hard politically to sell.

As to your specific questions you asked about how to reduce Social Security tax rates, I mentioned some of them. For instance, I would definitely tax fringe benefits. I think there is really no excuse as a matter of Social Security policy——

Chairman LAFALCE. Or at least excessive benefits.

Dr. STEUERLE. That's right.

Chairman LAFALCE. For the highly compensated.

Dr. STEUERLE. That's right, that's right. We know that the way we give tax benefits top health plans is very inflationary.

Chairman LAFALCE. The 1984 tax proposal was a good proposal with respect to taxation of benefits, by the way. It's just too bad that you had both labor and management opposing it.

Dr. STEUERLE. Like you, I would also consider strongly taxing Social Security benefits. I am not talking about fringe benefits now, but you mentioned taxing Social Security benefits of the elderly as well. It is part of the price that they would have to pay for this deficit reduction. I think that's a valid request to make as part of a package where everyone is asked to contribute. The issue of the cap is more complex.

Chairman LAFALCE. Because right now that is a windfall. I mean, there is just no reason for treating it the way it is treated. Maybe there is a reason for treating a certain portion of it as tax exempt, but not 50 percent. Is that correct, Mr. Myers?

Mr. MYERS. Yes; I certainly agree, and I have advocated elsewhere that there should be taxed as a good rough average, 85 percent of Social Security benefits.

Chairman LAFALCE. What is the justification for exempting 15 percent?

Mr. MYERS. Because that is roughly the amount of after-tax income that people contributed out of their own pockets at the maximum, as a proportion of the value of the benefits

Chairman LAFALCE. OK, they always say, "well, you are taxing after tax income, but only up to 15 percent of their benefits on the average."

Mr. MYERS. At most.

Chairman LAFALCE. At most, so at least 85 percent could be taxed and it is a windfall to them.

Dr. STEUERLE. Mr. Chairman, you could add in the other 15 just because of the Medicare nontaxability, as opposed to even trying to tax Medicare. You could go for 100 percent and fully justify it under pension analogies.

Chairman LAFALCE. You're right, but I won't.

Mr. MYERS. I would like to keep the two programs separate for consideration, and I am all in favor of taxing 85 percent, even though it would hit me hard. But I would say that any excess taxes that come in over what's being collected now should go into the general fund. It should not revert to the Social Security System.

Chairman LAFALCE. You tax Social Security benefits, that should have nothing to do with the Social Security fund. That should go to general revenues. That's an income tax. That's another crazy provision within our tax code that's been brought about by special interest pressure. It is irrational.

Mr. MYERS. I believed that such was the case when the 1983 amendments were enacted, but that was part of the grand consensus agreement.

Chairman LAFALCE. I know.

Mr. MYERS. Everybody had to give up some things that they didn't like, just as my very good friend, the late Claude Pepper,

gave up something that he was just never going to do, raising the retirement age.

Mr. POSHARD. Mr. Chairman.

Chairman LAFALCE. With the increase in life expectancy, that became a demographic imperative.

Mr. MYERS. That's what I thought too.

Chairman LAFALCE. Mr. Poshard.

Mr. POSHARD. Mr. Chairman, Dr. Steuerle didn't complete what he started.

Chairman LAFALCE. I'm sorry.

Mr. POSHARD. Dr. Steuerle started to say that removing the cap was a more difficult proposition and I would like to hear his response to that.

Dr. STEUERLE. My problems here are technical rather than issues of progressivity. The first issue was one that two of our speakers, Mr. Entin and Mr. Shapiro, debated a bit—the tie-in between the tax and the benefit structure.

If you totally eliminate any tie-in between tax and benefits structure, say for taxes above the cap, you really have changed the nature of the Social Security System. I am not necessarily opposed to that. I think there is a large transfer element in Social Security, and in some ways I wish we had set up a system that recognized that element better. But we haven't done that and it's difficult to cut off at a dollar level and say that from this point on the system is a transfer system and the rest is only a partial transfer system. I think that's very hard to explain, even if you might like it.

The second issue, I think, is one that would be of concern to small businesses too. The cap does serve as a very crude way of allowing people with capital income to treat themselves similarly within the Social Security structure. Let me rephrase that.

A noncorporate business generates capital income. That capital income for self-employment purposes is treated as subject to Social Security tax. We do that up to a maximum base and one gets a return in terms of benefits. We might think of most of that tax base as representing returns to labor, or at least the ideas of the entrepreneur in the firm.

When you get beyond that level, it is not quite so clear. There is a lot of capital investment. In a corporation, if you finance your investment through bonds, and you pay out interest in the corporation, that interest is not subject to Social Security tax.

If you remove the cap, you have a problem for the sole proprietor, say, who is making $200,000 a year, $100,000 of which might be thought of as capital income or equivalent to interest on bonds.

With no cap, you are subjecting all the income to Social Security tax, whereas in the corporate structure, you are not subjecting the interest payments on the bond to Social Security tax.

The problem of distinguishing between capital and labor income—which we dodge for the self-employed now by treating all returns of the sole proprietor as subject to Social Security tax—would be magnified and I worry a bit about that.

Mr. Myers again might have some thoughts on this. He has lived through this history.

Chairman LAFALCE. Dr. Steuerle, you have probably figured out a way to cope with that, haven't you?

Dr. STEUERLE. I am not sure I would do it with the Social Security structure. I think I would go back to thinking about how I wanted the combined income and the Social Security tax rates to fit together. I might set some maximum limit on what those two combined rates should be, even though it might require juggling income rates a bit.

Mr. MYERS. Mr. Chairman, if I might intervene a moment. From my limited view of Social Security as being a social insurance system, I think that a cap makes good sense.

From a tax policy standpoint, one might come out otherwise, but from a social insurance standpoint, the system is to provide a basic floor of economic protection for people, and the very high-earnings people should provide for their own economic security on their excess earnings.

Therefore, a maximum amount was established on both the amount on which contributions will be made and on which benefits will be determined. So, from strictly a social insurance standpoint, I think that a cap makes very good sense, and I would not like to see it removed.

Chairman LAFALCE. I am just trying to think of some way of paying for a cut in the Social Security payroll tax because you just can't say let's cut the tax and not pay for it, not make up for it, and add to the deficit. I mean, I just can't accept the thesis that it is OK to add $10, $15, or $20 billion in debt expense per year.

Mr. Entin?

Mr. ENTIN. A couple of quick comments. Dr. Shapiro is right about the deficit. We do mismeasure it. Professor Eisner at Northwestern has gone over this in testimony before Congress many times. A deficit of $80 billion where the GNP is growing faster than the debt by some substantial amount would not be damaging to the economy and in a sense, Congress may be straining too hard and doing too much damage to its own procedures to try and go beyond what is really technically necessary. On the question of the taxation of benefits——

Chairman LAFALCE. I think, though, a crucial point is what percentage of our Federal outlays are going for debt expense, and when we go from 7 percent to 15 percent, that is in the wrong direction.

Mr. ENTIN. But at $80 billion with the debt to GNP ratio plummeting, the debt service would be falling very sharply as a share of the budget.

Chairman LAFALCE. If that would be the case.

Mr. ENTIN. That is the case.

Chairman LAFALCE. The question is do you have full employment or not, too.

Mr. ENTIN. Yes; and that's a key point. You must do this in a way that doesn't damage growth or you are going to find a perverse result which you would want to avoid. I would suggest that you should attempt to avoid increasing marginal tax rates on labor and capital in a way that would reduce employment and investment.

Chairman LAFALCE. I should say, too, if you are going to adopt something like the Rostenkowski proposal, in order to address the concern about economic growth, it would be imperative to have a

monetary policy which takes cognizance of the dramatic change in fiscal policy and accommodates it to promote economic growth. A compact would be necessary, therefore, between the Chairman of the Federal Reserve Board and the President and the Congress should we ever take such heroic steps.

I think it is imperative that Dr. Greenspan—well, in fact, I am going to urge him later today or send him a letter as soon as I can get to it, and encourage him to make a public statement about the Rostenkowski proposal and to say that the Federal monetary policy would accommodate such a move.

Mr. ENTIN. Let me make two quick points.

Chairman LAFALCE. Yes.

Mr. ENTIN. In 1983, Gene and I went to the Finance Committee staff. Unfortunately it was late on a Friday evening and they were in no mood to listen. We warned them the taxation of Social Security benefits was being done improperly.

I think you should be aware that the way it is done now, with the 50 percent roll-in of benefits when you go over an income threshold it pushes your effective marginal tax right up by a half. If you are in the 28 percent bracket, you must pay tax on $1.50 which effectively puts you in the 42 percent bracket.

If you change the tax treatment of Social Security benefits, I would urge you simply to tax whatever amount of Social Security income you feel should be taxable—perhaps set some income amount at the bottom that would not be taxed, say an exemption of the first $4,000 of Social Security, and simply add amounts above that to taxable income. No roll-in, no threshold, no tax spike, because when you do that, the elderly can be pushed up into high tax rates that nobody else in the country pays.

To some extent, that's also the problem with removing the cap. You might push the tax rate on someone in the 33 percent bracket up say another 12 percent tax, after deductibility, to the 45 percent bracket. You do find that when you hit rates of that size, either on the elderly through the tax treatment of Social Security or on working people, you do start to affect their behavior, their use of tax shelters, their use of noneconomic types of behavior to try to avoid the rates.

You've brought up the concept of monetary policy. What we learned in the 1970's and 1960's was that monetary and fiscal policy aren't operating through the same channel.

If you ease on one, you can't necessarily tighten on the other with impunity. If you tighten on one, you cannot necessarily ease up on the other with impunity.

If monetary policy ultimately has its major effect on the price level, with only transitory effects on the real economy which seems to be the historical evidence, then the Federal Reserve should not ease monetary policy by changing its rate of money growth as we lower the deficit. It should hold firm.

Interest rates would perhaps tend to drift down as the inflation came down, which is what the Federal Reserve is trying to achieve. If the Government restrains spending growth, then the Government demands fewer resources out of the economy and interest rates will also tend to drift down.

That would,happen without the Federal Reserve's easing. If inflation is——

Chairman LAFALCE. It is imperative that interest rates come down and whatever policies are needed to do that——

Mr. ENTIN. If the Fed tries to ease in the usual meaning of the term, which is to push more money out into the economy, and the inflation rate as a consequence rises, it would hurt the economy. Bear in mind that we do not index depreciation as Treasury proposed in tax reform. We do not index the depreciation allowances, and therefore a higher rate of inflation reduces the real value of the depreciation writeoffs, raises the marginal tax on investment, and reduces the capital stock.

One of the things that Assistant Secretary Johnson said to me as he left Treasury—he was my immediate boss at that point, before he became Vice Chairman of the Federal Reserve—was that it was an awful shame we didn't get indexing of depreciation in tax reform. Now the only way for the Federal Reserve to lower the cost of capital is to bring down the inflation rate so that those depreciation reserves allowances retain their real value more strongly over time.

Indeed, that is correct. Only by bringing inflation down very gradually, so as not to trigger a problem with the economy, can the Federal Reserve do something to promote growth.

I think if we do lower the deficit through spending restraint and interest rates start down because of that, and we don't raise the tax on capital or the tax on labor, then the Fed's job should be easier. But it should be the same policy Mr. Greenspan has annunciated, that it would gradually reduce the rate of inflation to promote growth.

If you look at the late 1970's, what you will find is that the Fed, operating under an older theory, pushed out the money, raised the inflation, and pushed people up through the unindexed tax brackets, which raised the cost of labor and which raised the tax on interest and dividends. It inflated away the value of depreciation and raised the cost of capital and the economy stagnated.

Then the Fed thought that, since the economy was weak, it had to do more of the same, and it got into a vicious spiral. We don't want to start that again.

Chairman LAFALCE. Thank you. I appreciate that. Representative Poshard.

Mr. POSHARD. Mr. Chairman, I know you've been here a long time, but I want to ask one very simplistic question, and forgive the simplicity of the question, but I am a freshman and I want to do what's right back in my district.

I assume that you all agree that this deficit is a real problem for the economy of the country. You don't all agree. You don't feel like the deficit is a problem.

Mr. ENTIN. Not at levels below $100 billion.

Mr. POSHARD. I understand but it's not below $100 billion right now.

Mr. ENTIN. Close; one more year.

Mr. POSHARD. OK, but the accumulation of the debt, the debt that we have right now, do you agree that that's a problem for us,

the $1.3 trillion and the $100 billion continued deficit? Is it a problem, or isn't it?

Mr. ENTIN. I think it was this fiscal year, unless it was last, that the debt/GNP ratio began to fall. The economy is now growing faster than the debt.

If you are in that situation, you are over the hump. You are going to be all right because the debt service will begin falling as a share of the budget.

Mr. POSHARD. OK, well then I am thoroughly confused on the issue. My point is this, and it is a simplistic kind of question I want to ask you, but when I go back to my district and try to explain to my people on an issue, any issue, about what we need to do to be responsible for the overall welfare of the country, if I ask them for any kind of sacrifice whatsoever, it is always rejected. If it means something out of my pocket, whether I am a senior citizen, a veteran, I don't care who I am, I object to it.

Now, I want to do what's right and here's probably the most complex issue that I will ever have to discuss with my people, and there is not 1 in 1,000 in my district that will even begin to understand anything about this issue because they just don't. I am a Congressman and I don't understand all that much about the complexities of it.

I admire the chairman's intellectual level on these things, but I am not there and I don't know how——

Chairman LAFALCE. You can fool a lot of people and I have got you fooled.

Mr. POSHARD. Maybe so, but I am not there. The point I am asking is if I really wanted my people to be able to understand anything about this so that if I voted for Congressman Rostenkowski's bill or whatever bill which would require them to sacrifice, what is the simple thing that I can take home and say to my people that you need to understand if we don't solve this problem. If we don't solve this problem, this is going to happen. How can I get across to them?

Dr. STEUERLE. I'm not sure that they would necessarily believe me, but the way I would sell the package is by arguing that we essentially are trying to increase savings for future generations; that we went through a long period of dissaving; that this dissaving has raised enormously the interest on the debt; that that interest on the debt is preventing you and other Members of Congress from enacting programs that you think are worthwhile; and that in the long run, this dissaving is having an impact on what is available to their children.

Now, actually, I agree with Mr. Entin in part. I think we've actually come a long way. I think the argument for 1990 is not the same as the argument for 1986. If you look at the latter part of the Reagan era, it is totally different than the first part of the Reagan era in terms of what we did on the deficit.

We did this often without proclaiming the effort in very strong language, but there was complicit agreement between the executive branch and Congress to get the deficit down, and we did make good progress.

I still think we need to do more, in part because we built up this large stock of debt that simply is preventing us from doing other things.

The problem I have with Mr. Entin's argument, if I may say this, is we do go through cycles. If we've gone through 7 years of growth and we can't even get it to the point that we are reducing our debt, what do we do when we get to a down part of a cycle?

If we go to a recession, the debt goes up. If the minimum bound is that the debt never declines relative to the GNP, but everytime we go into recession the debt to GNP ratio increases, then we haven't solved our problem.

So we still have a problem here. It is not as great as it was a few years ago. Bottom line: the way I would try to sell deficit reduction is as something that you are doing for your children.

Chairman LAFALCE. If you subtract the Social Security surplus, the deficit increases tremendously. If you take, for example, the RTC outlays which are not presently counted as part of the deficit but should be, in my judgment—and I think most economists surely would agree—you increase it tremendously too.

As a matter of fact, I think you could easily go up from approximately $100 billion to $220 billion deficit and I think most independent economists would say that is a much more honest evaluation.

Also you have to look, too, at what you haven't been doing. We have had tremendous changes in our priorities. You know, the tax codes raises a lot less as a percentage of general revenues now, of total revenues and this payroll tax raises a lot more. Is that good?

The personal income tax raises a lot more than the corporate income tax now as far as the ratio is concerned. Is that good or bad? You can argue that we have had real increases in Social Security. We have real increases in the defense budget. We've had huge real increases in the debt expense.

We have real cuts, though, in education, in the environment, in transportation, infrastructure, human capital, physical capital of America—cuts for which future generations are going to have to suffer.

That has to be included as part of the equation, and we have had the best of economic times when we should have—that's when you get out, you don't go into deficits in great economic times, you go into deficit as a means of getting out of a bad economic time. That's when you must absorb deficits.

We have emasculated that future capacity. We are going to be in a situation, if we have an economic downturn, where we can't rely upon fiscal policy. Unfortunately, we are only going to be able to rely upon monetary policy it seems to me, which is a real, real problem.

But I've got to go. I am going to give Dr. Shapiro the last word because he has been chomping at the bit.

Dr. SHAPIRO. I just wanted to note that the administration's progress on the deficit has come through raising Social Security taxes; and that if you take the Social Security surplus out of the calculation, the deficit is going up.

The choice was made, in an interesting political way, to pass tax increases that would kick in much later, and so we didn't have the

debates over each increase in the Social Security tax, and whether the people wanted to raise those taxes in order to reduce the deficit.

Chairman LAFALCE. Yes; that's the irony in the situation. We say no new tax increase, but we hit a new tax increase every single year. It is just that it was passed years back. It was passed at the time of a crisis, it was a compact. You had to go for it because if you didn't go for that bill, the system would have collapsed so you had to hold your nose and go for it.

Dr. SHAPIRO. Right.

Chairman LAFALCE. With the promise that there would be reform. Remember there was the promise that we will make reforms. The reforms never really came.

Gentlemen, thank you very, very much. The committee is adjourned.

[Whereupon, at 12:40 p.m. the committee was adjourned subject to the call of the Chair.]

APPENDIX

OPENING STATEMENT BY CHAIRMAN JOHN J. LaFALCE

Today we will be addressing a subject which has become one of the major topics of concern here in Washington this year: payroll taxes. Our four witnesses are all experts in economic, tax, fiscal and social security policy, and I know that my colleagues join me in looking forward to hearing their views.

Many believe that the concern about payroll taxes is a new one. But the fact is that many individuals have been working on this question for a long time. For instance, I myself introduced a bill back in 1979 which would have removed the medicare and disability programs from the payroll tax, which I consider to be the most regressive we have, and funded them from general revenues. My rationale for this proposal was that these programs -- unlike the retirement element -- bear little if any relationship to the amounts contributed by individual taxpayers through FICA taxes and, therefore, would more logically be financed by a less regressive source of revenue.

I am hopeful that this hearing will help us learn more about the issues that surround the debate over payroll taxes in the American economy. We will gain some historical insights into payroll taxes and the social security system, and discuss a number of questions including: whether and the extent to which payroll taxes are regressive, their impact on small businesses, whether they constitute a tax on labor and, if so, whether such a tax is appropriate? Do payroll taxes disproportionately hurt smaller enterprise? Are they inflationary?

Another issue which the Committee would like to explore is the question of whether the social security program -- revenues or benefits, or both -- ought to be treated differently from other parts of the government in terms of calculating the deficit or in other ways.

Small businesses have a substantial interest in this subject, of course. Smaller businesses tend to be more labor-intensive than larger enterprises, and therefore payroll taxes are disproportionately important to this sector. And average wages and salaries in smaller businesses are less than in large businesses, meaning that less of the aggregate payroll in the small business sector would be above the $51,300 cap beyond which FICA taxes are not paid. For both these reasons, it could well be that small businesses are paying an unfair share of the nation's taxes.

Statement of the Honorable Joseph M. McDade
Vice Chairman
Committee on Small Business
U.S. House of Representatives
March 15, 1990

Mr. Chairman, I commend you for calling this hearing to discuss an issue that profoundly affects millions of Americans - the impact of payroll taxes on small businesses, specifically Social Security taxes. The Social Security tax rate has recently come to the forefront, and it is appropriate that we are meeting here today to consider the issue in the context of its current and potential effect on small businesses.

The Social Security system has been a tremendous success. It has provided for the needs of Americans who have spent many years working in both the public and private sectors and contributing to their local economies and communities. However, as we will hear from witnesses today, the current system is based on knowledge gained over 50 years ago, resulting in several incongruities and inequities. As one witness will share with us, it is possible for two individuals or companies who have the same income to pay a different

Social Security tax. Another witness will tell us that small businesses may bear a higher burden of the tax because they tend to be more labor intensive than larger or more established companies. It may be time to rethink our policy and adapt the system to the current environment. However, Congress must ensure that the integrity of the system is not undermined and that those who are working today can count on their benefits when they are needed tomorrow.

I would like to reiterate my support for the men and women across America who own and operate small businesses. As their elected representatives, we must continue to move this country toward an economic environment which fosters and strengthens their ability to enter and compete in domestic and foreign markets.

It is my hope that the gentlemen presenting testimony today will offer us insights into how the

present Social Security system can be improved, thus aiding us in making it more equitable for all.

JAMES H. BILBRAY
1ST DISTRICT, NEVADA

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THE HONORABLE JAMES H. BILBRAY
COMMITTEE ON SMALL BUSINESS

March 15, 1990

OPENING REMARKS

I commend the Chairman for calling today's hearing on the issue of payroll taxes and their impact on small business.

The issue of payroll taxes recently gained national attention when Senator Moynihan announced his proposal to cut the Social Security portion of the FICA payroll tax. This proposal grew partly out of the concern over the use of the Social Security Trust Fund to hide the true amount of this country's budget deficit, a concern shared by many members of this committee.

The impact of Senator Moynihan's proposal and other similar proposals on our nation's small business community is an issue that needs to be highlighted in the current debate over payroll taxes. I welcome today's witnesses and look forward to hearing their testimony.

STATEMENT BY ROBERT J. MYERS TO THE COMMITTEE ON SMALL BUSINESS,
HOUSE OF REPRESENTATIVES, MARCH 15, 1990

Mr. Chairman and Members of the Committee: My name is Robert J. Myers. I served in various actuarial capacities with the Social Security Administration and its predecessor agencies during 1934-70, being Chief Actuary for the last 23 of those years. In 1981-82, I was Deputy Commissioner of Social Security, and in 1982-83, I was Executive Director of the National Commission on Social Security Reform. Currently, I am Chairman of the Commission on Railroad Retirement Reform.

As background, I will first discuss the history of the payroll taxes which support the OASDI program and the Hospital Insurance portion of the Medicare program.

Next, I will deal with the present and future financial status of the Social Security program -- Old-Age, Survivors, and Disability Insurance (OASDI) -- as shown by the 1989 Trustees Report. I shall also discuss the problems that I see with the manner in which OASDI is being financed and funded under present law and why a return to pay-as-you-go financing procedure would be desirable. Such problems relate both to the program itself and to the general budgetary situation of the Federal Government.

History and Rationale of Payroll Taxes for Financing the Social Security Program

In 1934, the Committee on Economic Security made the studies that led to the enactment of the Social Security Act on August 14, 1935. The committee recommended that the retirement-benefits program should be financed for about the first 25 years by payroll taxes, equally divided between workers and employers. Then, ultimately general revenues would be introduced so that only two-thirds of the cost would be met by payroll taxes. However, the Roosevelt Administration changed this recommendation so that the entire cost in all years would be met by payroll taxes, and Congress adopted this approach.

I believe that payroll taxes are the appropriate major method for financing the earnings-related OASDI cash benefits, because the benefits and the supporting contributions are both related to earnings. This results in a certain degree of fiscal control, because proposals for increased benefits must be accompanied by increased taxes on the earnings on which the benefits are based. I further believe that it is undesirable to base part of the financing on general revenues, because then -- at least in times when budgetary restraints are less than at present -- irresponsible benefit liberalizations could be legislated without providing for the specific source of the necessary funds.

When disability benefits were enacted in 1956, their financing was accomplished through the same payroll tax as the old-age and survivor benefits (by increasing the rate). I believe that this is a perfectly appropriate way to finance the disability benefits, because they can be considered as being merely retirement benefits for a cause other than old age.

When Medicare was enacted in 1965, the Hospital Insurance portion was established on a compulsory basis, with the benefits to be provided to individuals who were covered by the OASDI program, and with the financing accordingly to be based on the same payroll tax as OASDI. The Supplementary Medical Insurance portion of Medicare was established on a voluntary basis, financed by those who elected to participate and by matching amounts from general revenues.

From the inception of the OASDI program, the payroll taxes were levied on earnings up to a maximum annual amount (or base). In most years, the base has covered 85 - 90% of all earnings in covered employment. The reason for establishing a maximum taxable base was to limit the size of the largest benefits payable -- on the grounds that persons with very high earnings should provide economic-security protection for themselves on their top earnings.

If one looks only at the OASDI tax, it can be seen as linear up to the base (i.e., the same rate for all), but regressive for earnings above the base (i.e., an increasingly lower rate, measured against total earnings, as earnings become larger above the base). However, when the combination of the taxes and the benefits, which are heavily weighted in favor of the lower paid, are considered, OASDI is progressive for earnings up to the base. And identical treatment as to both benefits and taxes applies to all persons with earnings above the base.

On the other hand, the HI program provides the same benefits regardless of earnings level and so is even more of a progressive nature than is OASDI. It could be argued that, from the standpoint of progressivity, no maximum taxable earnings base should be applicable for HI. However, I believe that -- for consistency and administrative simplicity -- the same base should apply as for OASDI, which has always been the case.

A favorite topic for debate and discussion by economists is who really pays the employer and employee OASDI-HI taxes, as against the simple answer by the casual observer that each party shares equally. Probably, the majority view is that the employer tax is really paid by the employee -- in the form of lower wages than would otherwise apply. To my mind, this argument and analysis is about as important and convincing as the theological one about how many angels can sit on the head of a pin! Nothing can ever be proved in the matter of incidence of any tax, especially over a period of time. In any event, the equal division of the OASDI-HI tax rate between employers and employees is aesthetically logical and appealing, and it seems to be the most reasonable way to finance the program.

Present Financial Status of OASDI Program

The OASDI system is currently in excellent financial health. The assets of the OASDI Trust Funds at the end of 1989 amounted to $162 billion (and were $110 billion at the end of 1988). The fund at end of 1988 was $71 billion higher than was estimated for that date in the pessimistic (Alternative III) estimate made when the 1983 Amendments were enacted -- on which estimate the short-range financing (for the 1980s) was founded in the legislation. Such excess of actual over estimated fund balance was $51 billion for the intermediate (Alternative II-B) estimate.

Under current law, large annual excesses of income over outgo -- which cannot properly be referred to as "surpluses" -- develop in the next three decades under OASDI. Such excesses, under the intermediate estimate, amount to about $70 billion in 1990, and increasingly larger amounts thereafter (e.g., $125 billion in 1995 and $200 billion in 2000). As a result, very large fund balances will be built up during the next four decades. The fund ratio -- which is the fund balance at the beginning of the year expressed as a percentage of that year's outgo -- peaks at 546% in 2015, when it is estimated at $7.2 trillion in current dollars, or $2.6 trillion in 1989 dollars. After 2015, the fund balance continues to grow in terms of current dollars, reaching a peak of $12 trillion in 2030. Under the pessimistic assumptions, the fund balance in 2015 is $3.3 trillion in current dollars, or $0.9 trillion in 1989 dollars.

After the end of the build-up period, the assets of the trust funds will be drawn upon, and, under the intermediate estimate, they will be exhausted in 2046. At that time -- if the benefit provisions are left unchanged -- additional financing in the form of higher payroll tax rates will be necessary. These increases would, on the basis of the intermediate-cost estimate, be 2.0% for both the employer and the employee over the rate now in effect for 1990 and after -- not an unmanageable rise.

No legislative intent has seemed to have been present, or expressed, to change over to this funding basis from the current-cost approach adopted in 1972 and supported over the subsequent years by the Board of Trustees. I am constrained to say that this procedure of building up a mammoth fund balance and then depleting it does not make good sense, especially when the program's cost (as a percentage of taxable payroll) is just as high in all years after 2030 as it is then.

Relationship of OASDI to the Budget

The manner in which, under present law, the OASDI Trust Funds first build up huge amounts in the next four decades and then decrease over the next two decades until being exhausted would have significant, deleterious effects on public-debt management and on Budget operations.

The relationship between the operations of the OASDI Trust Funds and the Budget is frequently misunderstood by the general public. Beginning in fiscal year 1986, the operations of the OASDI Trust Funds have been out of the Unified Budget, so that any excess of their income over outgo does not reduce the Budget deficit. However, anomalously, these trust-fund excesses of income over outgo are counted to meet the Gramm-Rudman-Hollings targets for Budget-deficit reduction. The result is thus virtually the same as if these trust-fund operations were included in the Budget, but the imbalance is really still there, and the National Debt is increased by the amount of the trust-fund excesses of income over outgo. In other words, the result of this procedure is, in the short run, to make the targets easier to meet and thus to make the Budget deficits appear smaller than they really are.

Widespread Fallacies about Financing Basis of OASDI

One myth is that the National Commission on Social Security Reform, in its recommendations which led to the 1983 Amendments, intended to have the system accumulate a huge fund while the baby boomers are employed, and then draw it down.

This was by no means the thinking of the Commission when it made its recommendations. Nor was it the intention of Congress when the legislation was enacted. No reference to any such intention can be found in the Commission's report or in the congressional debate.

Moreover, the information about the huge growth in the trust-fund balances had not been available when the Commission made its consensus recommendation, or even to Congress later when considering the legislation. Such figures were actually not available until mid-1983, although those with actuarial knowledge realized earlier that the approach taken would result in trust-fund buildups.

The Commission developed its recommendations by ensuring, as much as possible, that the year-by-year financing in the 1980s would be adequate and that, over the long range and on the average, sufficient financing would be provided. As is well known, the use of averages can be deceptive. That certainly is the case in this situation, as compared with looking at the year-by-year development of the trust-fund balances over the long run.

Accordingly, the building up of a huge fund that would peak in the midst of the baby boomers' retirement was a coincidence -- or, at most, an unintended by-product of the recommendations.

Various Methods of Funding OASDI

Next, I will briefly discuss the advantages and disadvantages of current-cost funding as against advance funding (either full-reserve or partial-reserve) for benefit systems with rising relative costs over the years, when considered as percentages of taxable payroll. The discussion thus applies to systems like OASDI. By current-cost, or pay-as-you-go, financing is meant that, on the whole, income will approximately equal outgo each year. Under this approach, a fund would be built up and maintained that would be approximately 6 - 12 months of outgo. Such a contingency reserve would be utilized to finance the system when business recessions temporarily reduce tax contribution income. It would then be built up again during times of economic recovery.

Certain matters in connection with funding relating to plans of individual employers (especially non-governmental ones) are not applicable to national social insurance systems -- for example, the possibility of going out of business or of not having new entrants. The following discussion will relate only to the OASDI system.

The advantage of full-reserve funding -- and, similarly, to a considerable extent, of partial-reserve funding -- is simply that thereby the contribution rate ultimately will be lower than it would be under current-cost funding. This occurs because the interest on the assets accumulated from the excess of income over outgo in the early years of operation is available to meet the outgo. Assuming that the assets of the OASDI Trust Funds are invested in government-debt obligations (as seems to be the only proper procedure), the resulting interest income is "valid". If these obligations were not held by OASDI, they would have been held by the general public, and the same interest on them would have been paid.

It could be argued that the higher contribution rates in the early years, and the lower ones later, under full- or partial-reserve financing would result in greater intergenerational equity. This is so because the initial covered population, especially those near retirement, receive "windfalls" (as measured by considering the value of their benefits as against the contributions paid by them or on their behalf) as compared with the situation for young new entrants. Accordingly, a level contribution rate (or, even, a higher rate in the early years than later) -- as might be provided under a full- or partial-reserve funding approach -- would alleviate the situation.

The disadvantages advanced against full- or partial-reserve funding are more of a "political" nature than of a theoretical, actuarial nature. One problem would result from the huge amounts of investments involved, which could absorb a very large portion of the National Debt (or even all of it) and thus not leave sufficient for the general investment market. Another problem might be that the ready availability of large amounts of money that could easily be borrowed by the General Fund of the Treasury would encourage excessive governmental spending.

Yet another problem is that the presence of a very large fund balance could create politically irresistible demands for greatly liberalized benefits on the grounds that "all that money is there". The difficulty, then, if such liberalization did occur, and the fund balance were drawn down, would be that the OASDI costs in future years would be greatly increased over those under present law -- and the long-range financing problems would become greater.

Actual Funding Basis of the OASDI Program

Next, I will take up the subject of how OASDI has been funded over the years. The original system (1935 Act) was funded on a partial-reserve basis -- and not on a fully-funded basis, as sometimes alleged. The 1939 Act, which expanded the program to include auxiliary and survivor benefits, was also funded on a partial-reserve basis -- and did not institute current-cost funding, as is often erroneously stated. However, the system was then funded at a lower relative level than under the 1935 Act.

During the 1960s and 1970s, the emerging experience of OASDI was such that the funding was actually on a more or less current-cost basis. However, until 1972, the funding basis as to the estimated future experience was still on a "partial-reserve" basis. The 1972 Act introduced the concept of current-cost funding over the long range, but the 1977 Act (and the 1983 Act as well) did not follow this principle, but rather resulted in the build-up of a mammoth fund balance -- and then its depletion before the end of the 75-year valuation period.

Desirable Changes in Financing of OASDI Program

I believe that the financing basis of the OASDI program should immediately be changed back to the pay-as-you-go basis that has been followed, in effect, for the past few decades. This would be accomplished admirably by Senator Moynihan's bill. The fund ratio of the OASDI Trust Funds at the end of this year will be very close to 100%, which, in my actuarial opinion, is adequate for pay-as-you-go financing to be viable.

I well recognize that the actual experience over long-range periods will not necessarily follow the intermediate assumptions. This, however, does not create any problem, because the contribution schedule will necessarily, in any event, need to be re-examined from time to time as the experience unfolds. Then, adjustments in the schedule -- either upward or downward -- can readily be made.

Some individuals have asserted that pay-as-you-go financing will mean permanently higher tax rates over the long run than under present law. They base this viewpoint on the fact that the ultimate tax rate for both employers and employees under Senator Moynihan's bill is 8.1%, as against the 6.2% scheduled under present law for all future years. However, they forget that, under present law, once the fund balance has been depleted (in some 55 years, under the intermediate estimate), the contribution rate must increase to the same 8.1% as under pay-as-you-go financing if the benefit provisions remain unchanged. In other words, if OASDI is financed on a pay-as-you-go basis as in Senator Moynihan's bill, payroll tax rates would be lower than now scheduled for the next 25 years, the same for the next 5 years, and somewhat higher for the following 25 years, but the eventual rates ultimately will be about the same.

Some people have expressed the fear that benefits are more likely to be reduced under pay-as-you-go financing than under the present "roller coaster" financing method. This is not at all likely to be the case because, as just indicated, the tax rates under pay-as-you-go financing are not all that different from what would have to be done under present law. In essence, changing to pay-as-you-go financing is not a drastic change in direction for the Social Security program or an abandonment of the consensus reached in connection with the 1983 Amendments. Rather, it is merely a fine tuning of the financing procedures.

I believe that pay-as-you-go financing would increase public confidence in the OASDI program. No longer would there be the confusion and the fear of "thievery" and "embezzlement" in connection with the use of trust-fund monies to balance the budget.

Some people also question whether the level of the OASDI Trust Funds -- at about 100% of annual outgo currently, as well as estimated to be the case over the 75-year valuation period, as shown by the accompanying chart, prepared by the Office of the Actuary, Social Security Administration -- would be adequate if poor economic conditions should occur. It should be recognized that, under such circumstances, the contribution rates could be increased somewhat to provide the necessary financing (and still be lower during the next two decades than under present law).

A further safeguard under such economic circumstances is the stabilizer provision already in law, which provides for the Cost-of-Living Adjustments to be the smaller of wage increases or price increases when the fund ratio is low (under 20%). This provision is certainly equitable to the beneficiaries, because one can well argue that their COLAs should not be larger than the wage increases given to the workers who are currently making contributions to support the system. At the same time, any part of the COLA which is "lost" when wages increase less than prices is desirably restored when the normal situation of wages rising more rapidly than prices again occurs (and the fund ratio is substantially higher -- over 32%). It is my belief that this existing provision should be changed so that the trigger level is somewhat higher than a fund ratio as low as 20%, and that certain technical changes in it are desirable for consistency and comparability.

The Role of OASDI Operations in the Gramm-Rudman-Hollings Targets

In my view, the operations of the OASDI program should be removed from the computation of the Gramm-Rudman-Hollings targets for the Budget deficit reductions. The deficit situation would then be portrayed vividly and honestly. However, if we go to pay-as-you-go financing, as under Senator Moynihan's bill, this question becomes relatively moot, because the targets would be only minimally affected whether or not the OASDI operations were so included.

Some people believe in the large build-up of the OASDI Trust Funds for budgetary reasons and/or for encouraging greater savings efforts in our nation. This is despite the good reasons against having the Social Security program distorted to become a mechanism for the manipulation of fiscal affairs, as Dean Brown so sagely warned against. I might say -- not entirely facetiously -- that if this use of the program is so desirable, then why not increase the contribution rates and build up even larger fund balances, so that the program is more nearly actuarially fully funded, as ERISA requires private pension plans to do.

Investment Procedures for OASDI Trust Funds

The assets of the OASDI Trust Funds are invested by the Secretary of the Treasury solely in U.S. government obligations, except for a relatively small cash working balance. The securities can be of any of three types -- obligations bought on the open market, obligations bought at issue (as part of a new issue offered to the public), and special issues. In the actual operations in the past, almost all of the investments have been in special issues. The law provides that the special issues shall bear an interest rate equal to the average market yield rate on all U.S. government obligations with at least 4 years to go until earliest maturity (as of the issuance date of the special issue), rounded to the nearest 1/8%. No specific provision applies as to the period until maturity for the special issues, but in practice, it is attempted to have them in a maturity schedule spread equally over a period of 15 years. Investment is also permitted in debt obligations that are guaranteed as to both principal and interest by the U.S. government, such as those of the Government National Mortgage Association.

At the time of the 1983 Amendments, both the House and Senate versions of the bill contained provisions for significantly revising the investment procedures. The proposed procedure, which had been recommended by the National Commission on Social Security Reform, would have been similar to money-market funds with varying market interest rates each month, with such rates being determined on the same basis as had been previously followed (and still is).

This revised investment procedure would have added to the general public's understanding of the investment situation. Over the long run, it would probably have had a neutral cost effect. The proposed new basis was dropped in the joint conference between the House and the Senate, because of the belief that there would be a declining trend in interest rates in the next few years. If that occurred, the trust funds would have lower investment returns than under the old procedure.

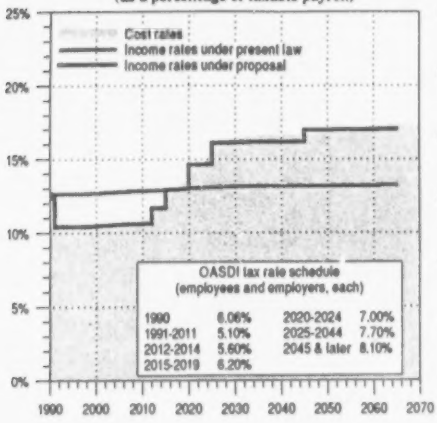
It has sometimes been suggested that there should be more freedom in the investment procedures for the trust funds, such as active asset management and investment in government-agency instruments (e.g., Fannie Mae), state and municipal bonds, and stocks and bonds of private companies. I believe that, considering the nature of the trust funds and their large size (even under pay-as-you-go financing), anything but an automatic investment procedure would be undesirable. The guiding priciple in this respect, as well as in other fiscal ones, should be neutrality of effect.

Conclusion

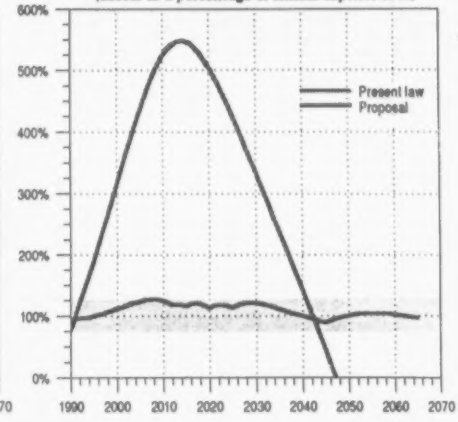
In summary, the time has arrived when the financing of the OASDI program should be rationalized, stabilized, and made crystal clear by going to a pay-as-you-go basis, as proposed by Senator Moynihan. The system would then be financed on a clear, visible, and understandable basis, and would be actuarially sound. Such a change would not endanger the benefit rights of either current beneficiaries or those who will come on the rolls over the long-run future. At the same time, this would give the nation a better and clearer opportunity to solve the problems with the Budget and with the savings capacity of its citizens.

Projected OASDI Financial Operations Under Senator Moynihan's Bill, S. 2016, As Introduced

OASDI cost rates and income rates
(as a percentage of taxable payroll)



OASDI contingency fund ratio
(assets as a percentage of annual expenditures)



Calendar year	Income rate	Cost rate	Balance	Contingency fund ratio
1990	12.35%	10.52%	1.83%	77%
1991	10.40	10.55	-.15	94
1992	10.41	10.58	-.17	98
1993	10.41	10.57	-.15	96
1994	10.41	10.51	-.10	97
1995	10.41	10.45	-.03	99
1996	10.41	10.40	.01	101
1997	10.41	10.35	.06	103
1998	10.41	10.32	.09	106
1999	10.44	10.31	.12	108
2000	10.45	10.28	.17	111
2005	10.54	10.26	.28	123
2010	10.61	10.76	-.16	124
2015	12.88	12.03	.85	115
2020	14.57	13.70	.87	112
2025	16.06	15.22	.83	113
2030	16.11	16.22	-.11	120
2035	16.14	16.60	-.46	110
2040	16.15	16.57	-.42	99
2045	16.95	16.56	.40	89
2050	16.96	16.73	.23	99
2055	16.98	17.00	-.02	103
2060	16.99	17.19	-.19	101
2065	17.00	17.29	-.29	96

Period	Summarized income rate	Summarized cost rate	Summarized balance	Alternative balance
1989-2013	10.68%	10.53%	0.15%	- - -
2014-2038	14.92	14.90	.02	- - -
2039-2063	16.79	16.86	-.07	- - -
1989-2063*	13.85	13.70	.15	-0.01%

* Summarized income rate, balance, and alternative balance for 1989-2063 include beginning trust fund assets. Alternative balance also reflects requirement for ending fund assets equal to 100 percent of annual expenditures.

Note: Estimates are based on the alternative II-B assumptions from the 1989 OASDI Trustees Report.

Office of the Actuary
February 1, 1990

Testimony of

Robert J. Shapiro

Vice President, Progressive Policy Institute

before the

Committee on Small Business

United States House of Representatives

March 15, 1990

Mr. Chairman and distinguished Representatives, it is a privilege to be here today and to explore with you the costs and benefits of reducing or reforming the payroll tax.

There are few current legislative issues more important than Senator Moynihan's proposal to cut payroll taxes, because at its center is the question of how the national government is to finance its operations. The particulars of Senator Moynihan's proposal have elicited considerable dispute among politicians, economists and other interested people. But there is no debate over how payroll tax revenues are raised, nor over how these revenues are presently used. Moreover, few economists would challenge the view that there are systematic biases in the incidence of payroll taxes which affect the distribution of resources in the business sector and the distribution of after-tax wealth among private individuals.

These significant biases arise from the fact that the burden of the social security tax, the nation's single largest tax on business activity and the second largest tax on individuals, is partly determined by factors related, not to the goals of social insurance but to the way that different businesses naturally allocate their costs and the way that different individuals produce their incomes.

To begin, social security revenues are raised by taxing an increment of the market value of wage labor, while exempting from tax all income generated passively through owning property or capital assets. Moreover, the increment of labor value subject to tax declines from 100 percent to zero when the value passes a threshold -- the "cap". Finally, the rate at which labor is taxed is not a constant portion of its total value, because the tax rate is the same for all wages earned below the cap.

This structure determines who pays for those operations of government that are financed through payroll taxes; by taxing only the factor of wage labor in production, the social security

tax focuses this financing burden on businesses that must dedicate a larger than average portion of their total costs to such labor, and on individuals who must depend more than the average on their own wage labor for income.

With regard to business, to the degree that companies depend on property or capital assets to generate income, their relative tax burden is reduced. This is likely to concentrate the tax burden somewhat on businesses that are relatively less capital-intensive, which tend to be smaller businesses and younger businesses. Similarly, a business's tax burden is limited to the degree that its labor costs are concentrated in high-wage and high-value workers. This tends to shift the relative tax burden sectorially rather than categorically, to industries that are relatively less dependent on high-wage labor, such as retail, agriculture and food and health services. Finally, in contrast to the corporate income tax, a firm's payroll tax liability depends not on generating profits, but on its natural and relative dependence on a particular form of wage labor. We would expect this element to favor businesses that can pass on to their customers all of any increase in these labor costs, which in turn tends to favor corporations in industries that are cartelized, protected or otherwise insulated from strict competition. Businesses that are unable to pass through such increases must offer them by reducing other costs, including direct wage costs.

To sum up, the structure of the payroll tax paid by businesses tends to channel economic resources to older, larger businesses, to enterprises operating in less competitive environments, and to firms that are more dependent on highly skilled labor. Among businesses that bear a relatively larger burden of the payroll tax -- younger, smaller businesses operating in a highly competitive market, with a higher than average proportion of moderate and low-wage workers -- increases in the payroll tax may tend to reduce the growth rate of wages. While the magnitude of these biases, especially in affecting the availability and cost

of capital, may not be great under certain macroeconomic conditions, in my view their impact on the rates of return among industries and firms is definite.

There are corresponding biases in the incidence of the payroll tax on individuals, which strongly concentrate the burden of the payroll tax on moderate and average-income people. First, the tax burden is borne entirely by persons who generate their incomes in the form of wages and salaries, which reduces the relative and absolute tax burden for high-income persons, who generate a significant share of their incomes through property income, capital gains and other capital income. Capital gains alone account for more than half of the incomes of taxpayers who report making $100,000 or more a year. This bias is reinforced by the "cap," which subjects to tax those marginal dollars earned only by persons with incomes below that cap -- $53,400 in 1991.

Finally, the flat tax rate on wages below the cap does not offset or moderate the previous biases. As a result, a worker earning a typical American salary of $20,000, or $40,000, or $50,000, must pay an effective individual payroll tax rate of 7.65 percent; the effective payroll tax rate falls to 4.05 percent for someone earning a salary of $100,000. For a person earning a salary of $200,000, such as President Bush, the effective social security tax rate declines further, to 2.03 percent. And persons with incomes of any level, earned not as a salary or wages but through rents, dividends, interest or capital gains, or through certain kinds of business partnerships or personal corporations, pay an effective payroll tax rate of nothing on all such income.

What are the justifications for the biases in the incidence of the payroll tax?

On the business side, taxing only direct wage costs offers a simple and efficient way of collecting revenues from a large and, in this respect, homogeneous tax base. To the degree

that these revenues are dedicated to providing workers with retirement income, it is reasonable to base retirement income on their wage effort or labor value.

As a levy on individuals, the justification for taxing direct wages income alone, and at a flat rate, is that it offers an efficient and simple means of collecting revenues. (In contrast to capital gains and some forms of property income, there are relatively few complications regarding the value which should be subject to tax.) This rationale does not apply to the "cap," which limits the tax base without providing any efficiency benefits. Finally, the progressive distribution of social security benefits is offered as a post hoc justification for the regressive distribution of the individual payroll tax burden.

This analysis provides two critical insights for the current debate. First, the cap on income subject to social security tax, on both the business and the individual side, is unjustified, both economically and in terms of fairness. The cap reduces the efficiency of the payroll tax system by arbitrarily restricting the payroll tax base; it further makes the system more regressive by strongly favoring marginal wages and salary earned by high-income persons over that earned by moderate or average-income persons.

Second, the traditional rationales for the payroll tax system do not support its use for raising resources for non-social security spending. From the vantage of the individual payroll taxpayer, there is no logical or historical basis for requiring that only those earning a middle-class income or less, and only those without income-generating capital or property assets, should bear all of the burden of paying for a portion of all non-social security programs.

On the business side, there is no economic or political rationale for targeting only certain wage and salary costs, if the revenues are used to fund non-social-security spending. It is inefficient to use the tax system to favor companies that are large over those that are

small, firms that are old over those that are young, enterprises that employ a smaller than average proportion of less-skilled workers over those employing a larger that average share of such workers, and firms that operate in cartelized, protected or otherwise less competitive environments over those subject to stricter competition.

Despite these serious flaws, the payroll tax system operates with reasonable effectiveness and efficiency, and it should not be scrapped. However, Congress can address the basic concerns contained in Senator Moynihan's proposal -- the regressive effects of using social security revenues to reduce the operating deficit, and the increasing burden of social security taxes on average families and on small, labor-intensive businesses -- by reforming two features of the current system.

In the interest of fairness, Senator Moynihan proposes to deny other programs the use of payroll tax revenues by reducing payroll tax rates to the level required only to pay for current benefits. This pay-as-you-go system would eliminate any surplus social security revenues that could tempt any future Congress or president. However, this approach also would increase federal borrowing by some $40 billion a year, raising interest rates and thereby depressing investment and long-term growth.

Establishing a responsible pay-as-you-go system, therefore, requires that Congress find broadly-acceptable alternate sources of revenue or program savings. Without such alternative resources, enacting a pay-as-you-go system would rapidly raise interest rates by as much as two-to-four percentage points, curtailing investment and long-term competitiveness. However, if Congress did raise the requisite revenues from other sources, and offset the effect on federal borrowing of such deep payroll tax rate cuts, the economic results would be positive: The benefits would include lower inflation and lower interest rates throughout the 1990s, and

consequently higher real GNP growth, then currently forecast. There is one caveat: If the offsets include higher corporate tax rates, the changes would also reduce capital formation, cutting American's long-term standard of living.

There is a simpler way of preventing social security revenues from being used to finance other programs: For purposes of Gramm-Rudman budget calculations, exclude all social security spending and revenues. Complying with the Gramm-Rudman targets under these conditions, however, ultimately would require the same broad consensus on new sources of revenue and program savings.

Moreover, this reform would not ease the burden of payroll taxes on moderate and average-income families, who watched their payroll tax burden grow more sharply in the 1980s than at any time since it was created in the 1930s. In the last decade, the social security tax rate was raised seven times -- five times in the last six years alone. A worker's maximum social security taxes jumped from $1,500 to $3,900 in the 1980s, a 66 percent increase after inflation. And on top of this burden is the injustice of the Treasury using some of these additional revenues not to build up a surplus to pay for benefits in the 21st century, but to support other current programs.

There is a simple way of reducing payroll taxes without expanding the federal deficit or touching the trust fund -- and at the same time reduce the arbitrary economic distortions from the current system. The strategy is the same as the 1986 tax reform: Raise the same amount of revenues by lowering the payroll tax rate while expanding the payroll tax base. And the most efficient way of expanding the tax base would be to repeal the cap on wages and salaries subject to social security taxes.

Based on data from the social security trustees' annual report, removing the cap would subject to social security taxes another $290 billion in covered wages and salaries in 1991.

By so doing, Congress could raise the same revenues projected under current law for the trusts funds while cutting the FICA tax rate from 7.65 percent to 7.25 percent (5.85 percent for OASDI, 1.4 percent for HI).

That would reduce social security taxes for some 120 million Americans earning less than $60,600 in wages and salaries -- about 97 percent of all wage and salary workers. An average worker earning $25,000 a year would get $100 in tax relief, while someone earning $54,300 would save the maximum $217 -- without affecting the trust fund or the deficit. On the other side of the ledger, social security tax payments would go up for some 3 million high salaried people -- managers, doctors, lawyers and bankers in the top 2-to-3 percent of wage and salary earners who now exempt much of their earnings from the payroll tax.

This change would eliminate the payroll tax system's bias in favor of firms that must employ a large share of high-wage labor, and reduce the bias against many labor-intensive small businesses. And it would do by providing a form of tax relief for the vast majority of Americans that would also promote greater fairness in the entire tax system.

* * *

SOCIAL SECURITY TAXATION

Statement before the Committee on Small Business
U.S. House of Representatives

March 15, 1990

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Senior Fellow

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SOCIAL SECURITY TAXATION

Mr. Chairman and Members of the Committee:

Any discussion of Social Security must start with one incontrovertible fact: the Social Security program has been a remarkable success. It has provided a stable source of income for the elderly. It has provided millions with the security of health insurance. Unlike so many other of our attempts to reduce poverty rates, Social Security is primarily responsible for reducing the poverty rate for the elderly below the average rate for the rest of the population.

If I had to summarize in a single sentence why we are having this discussion today, it is that the Social Security System has reached middle age. This is neither a positive nor a negative statement. It is simply a reflection that policy changes toward Social Security being contemplated today are very different from those of the past.

Let me put it another way. The Social Security System we drive around in today is like a Desoto. Now most of the political arguments on Social Security are between those who want to continue driving this Desoto and those who want to abandon it in favor of what came before: the horse and buggy. But anyone who has examined the vehicle closely knows that, along with its extraordinary success, it still contains many components that represent the best technology of a bygone era, not the knowledge of today.

The technology of this bygone era included the following. For several decades, the principal means by which the government would finance shifts in functions would be to increase tax rates on workers, mainly workers at moderate income levels. The evolution of Social

Security, for instance, has been so steady that it can be traced by as simple rule of thumb: three percentage points per decade. For almost half a century, by the end of every decade the combined Social security tax rate has been increased by almost 3 percentage points, reaching 3.0 percent in 1950, 6.0 percent in 1960, 9.6 percent in 1970, 12.26 percent in 1980, and 15.3 percent in 1990.

Increases in the Social Security tax rate, along with relative declines in the value of the personal exemption in the individual income tax, are the two most dominant tax increases of the entire post-World War II era. Together they dwarf every other tax change. Together they have successfully paid not simply for the expansion of the Social Security and Medicare systems, but for many other expenditure and tax changes, including expenditures hidden in the tax Code and reductions in both corporate and excise taxes.

These tax increases on workers and households with dependents have been enacted in both Republican and Democratic Administrations, with little fanfare, without conscious choice or recognition by many policy makers, with only occasional publicity, and almost always without a vote during each year that a tax increase actually took place. Debate instead proceeds on the changes paid for by these tax increases. Democrats and Republicans, for instance, most likely will engage in extensive discussions this year on whether or not to provide yet another savings incentive. They will hint that these types of changes pay for themselves. Yet what is the reality? The reality is that these changes cannot be accomplished without increasing the relative tax burden on workers and probably increasing their real burdens as well.

Over and above real tax increases due to real growth in the economy and tax base changes, the 1988-1990 Social Security tax rate increases are responsible for increases in taxes

of over $25 billion per year, while Social Security tax rate increases since the end of 1983 raise almost $50 billion annually, and since the end of 1980, close to $80 billion annually.

Let's see what has happened to moderate income workers who still earn considerably less than median income in the economy. As Paul Wilson and I have shown, the direct tax burden of a family that earns cash wages of about one-half median income--that is, a working family with a little more than $20,000 in income in 1990--has gone up from almost nothing in 1948 to about one-fifth of income today.

TAX RATES FOR FOUR-PERSON FAMILIES AT ONE-HALF THE MEDIAN INCOME

Year	Average Income Tax Rate	Social Security Tax Rate
1948	0.00%	2.00%
1954	0.00	4.00
1960	0.15	6.00
1966	2.72	8.40
1972	4.37	10.40
1978	4.73	12.10
1984	6.50	13.40
1990	5.57	15.30

SOURCE: Eugene Steuerle and Paul Wilson, "The Taxation of Poor and Lower Income Workers," in Ladders Out of Poverty: A Report of the Project on the Welfare of Families, edited by Jack A. Meyer, Washington, D.C.: American Horizons Foundation, 1986, and data furnished by Al Lerman, U.S. Treasury Department. Reprinted in Tax Notes, February 16, 1987.

An Analogy With Changes in the Personal Exemption

There are some who make an analogy between the recent proposal of Senator Moynihan and the tax reductions proposed by President Reagan in 1981. As is well known, the 1981 reductions had significant effects in later years upon the deficit and also upon the evolution of the budget and the tax system. With our deficit still much higher than sound fiscal policy would dictate as reasonable, the fear is raised that Social Security tax reductions would simply exacerbate deficits for years to come.

I prefer a different analogy. In the late 1970s, I began research on historical changes in the individual income tax. One conclusion drawn from this research was that declines in the value of the personal exemption over time were paying for an enormous range of other regressive and inefficient changes in the tax Code. In addition, this decline in the value of the personal exemption was increasing taxes on the poor and on lower income workers at a significant rate. Finally, households with dependents--not other households--were bearing almost all of this increased tax burden.

This research eventually was to lead to one of the most important liberal-conservative coalitions of the decade of the 1980s: a coalition of those concerned with taxing the poor and those concerned with the taxation of the family.

Now, initially, there was great opposition to this coalition from the same group of people who today will tell you that budgetary deficit issues are so important that almost nothing else in the expenditure or tax system matters. When President Reagan, as a result of being presented these data, came out in support of an increase in the personal exemption in 1983, it is true that there was no room in the budget for such an increase. By itself, this proposal was attacked as being fiscally irresponsible.

The formation of this coalition, nonetheless, was invaluable only a year later in the development of tax reform. As Economic Coordinator of the Treasury's tax reform effort, I was allowed to find ways to pay for this change in the personal exemption as part of a broad tax reform package. In the context of other changes in taxes and tax expenditures, an increase in the personal exemption could be made part of program of sound economic and fiscal policy.

I draw this analogy here because I believe the proposal to reduce Social Security tax rates is at the same early stage of development. To be successful, Social Security tax rate reduction must be put into a package that takes into account both short-run deficit concerns and long-run Social Security and Medicare concerns. A package of changes, of course, would recognize explicitly what is always true, but sometimes hidden: that every change in expenditures or taxes is balanced by an offsetting change elsewhere. I realize that the conventional wisdom of the day is that government must stagnate because such trade-offs cannot be made. In my view, this conventional wisdom is wrong and reflects a very narrow reading of history.

Why do I think that a package or combination of changes is possible--indeed, eventually unavoidable--in Social Security? As I mentioned earlier, we are driving around in a Desoto. It is becoming more and more incongruous with its surroundings.

What are some of these incongruous features of Social Security?

- It is extraordinarily inequitable. Two workers with the same amount of income often pay significantly different rates of Social Security tax. Those with cash income pay much more tax than those who receive nontaxable forms of compensation.

- It discriminates against women and minorities who are more likely to receive their compensation in the form of cash rather than nontaxable fringe benefits. The rapid increase in the rate of growth of fringe benefits add to this discrimination.

- It discriminates against secondary workers--again, primarily, women--by often giving them absolutely zero benefits for their tax contributions. In fact, rather than distribute burdens on a more fair basis, this transfer of funds from working women, and decline

in household replacement wages for many households with working women, was one of the major ways that Social Security was able to come closer to remaining actuarially sound over the past couple of decades.

- It discriminates against those who work most of their adult years by giving them absolutely no benefits for several years of work. Social Security limits the number of years that can be counted toward benefits.

- Although the system as a whole is progressive, it is turning more regressive as the number of years in retirement increase. For a typical couple, at least one spouse will be in retirement over two decades. The cost of old age insurance has already increased by about 1/3 because more and more years of retirement are supported. Despite a small increase in retirement ages enacted in the 1983 legislation, costs will continue to increase as we move into the 21st century simply because Social Security fails to index for increases in lifespans. Yet these payments to the younger among our elderly are being made by a population of workers who, on average, have lower after-tax incomes, lower wealth, and higher poverty rates than the younger elderly they are supporting. And, by the way, these workers are also supporting their children--a group that has been forgotten for some time now on both the expenditure and the tax side of the federal budget.

- Because of longer life spans, the Social Security System is also becoming less progressive among beneficiaries. In effect, a larger and larger share of benefits go to those less and less in need rather than to those in their last years of life and more likely to have chronic health needs. This issue arose in a draft study that I completed for the Treasury Department entitled: "Financing Health Care for Tomorrow: A Report to the President and to the Congress on Long-term Care and Catastrophic Health Needs." We could easily provide greater long-term care insurance if we were willing to follow the principles on which Social Security was established, but have become increasingly disregarded: that the System is meant to help individuals when they are least able to care for themselves."

- Because a greater and greater share of Social Security benefits are being paid in the form of health benefits rather than cash, the choices of the elderly are becoming more and more constricted. Adherence to the principle that the elderly should be given maximum choice over their affairs is now threatened in a subtle way by the enormous expansion in the cost of Medicare, Supplementary Medical Insurance, and Medicaid rather than in an expansion of cash benefits to pay for health needs. (For example, the Federal government tells you that you must buy acute medical insurance when you may have greater need of insurance for chronic or long-term care needs.)

- Elderly individuals who work effectively pay significantly higher tax rates than do many other elderly individuals with equal incomes. In fact, because they engage in leisure activity, these latter individuals may actually have a greater ability to pay taxes.

- o An increasing portion of Social Security taxes and income taxes are doing nothing more than subsidizing suppliers of medical care. If medical inflation had been constrained since 1965 to the general rate of inflation, federal, state and local expenditures would be more than $85 billion less today without any decrease in medical services provided.

- o And, as every single policy maker in Congress and the Executive Branch knows, the Social Security/Medicare System as a whole is insolvent. By waiting for the appearance of a crisis before anything is done, of course, we display the same mentality that has been shown in the savings and loan and Housing and Urban Development situations. We increase significantly the possibility that the inevitable changes will be more inefficient and unfair than necessary.

Let me add that important improvements in the fairness and efficiency of the Social Security tax and benefit structure can be accomplished easily without any change in old age benefits being provided to current retirees and without any decrease in the overall progressivity of the system. In addition, I believe that there are easy ways to put some amount of funding of Social Security off-budget (but not the whole System) without changing benefits, violating budgetary and fiscal policy principles, or changing the overall progressivity of the System.

In summary, Social Security tax rate reduction is a logical consequence of moving away from an era when most major federal policy changes are required to be financed by workers and those who care for dependents, that is, by those who accept responsibilities in society. Social Security rate reduction should be made part of a package that takes into account deficit concerns in the short run and the long-term structure of Social Security and Medicare in the long run. Rate reduction is a reasonable and essential component of a broad-based attempt to come to grips with some of the clearly regressive, inefficient, and inequitable aspects of the combined Social Security tax and benefit structure.

Statement of Stephen J. Entin
Institute for Research on the Economics of Taxation

before the

House Committee on Small Business
Hearing on
Proposals to Lower the Payroll Tax Rate

March 15, 1990

This statement is made in support of proposals to reduce the payroll tax rate, specifically, that part of the payroll tax rate related to the retirement and disability portions of social security (Old Age and Survivors Insurance and Disability Insurance -- OASDI), to levels more nearly equal to the current outlays for retirement and disability benefits. If done without unnecessary increases in other taxes, such a rollback could increase employment and GNP substantially over the coming decade. The statement focuses on the economic benefits of a payroll tax rollback, with particular attention to the proposals submitted by Senator Daniel P. Moynihan and Senator Robert W. Kasten, Jr.

Summary and Conclusions

Charges that the payroll tax is regressive or that social security funds have been misused are largely spurious, and are not the real reasons why the payroll tax should be cut.

Economic gains are the reason to cut the payroll tax rate. A cut of about 2 percent of payroll would save about 700,000 to 1.1 million jobs over ten years; raise GNP by about 0.5% to 0.6% (about $30 billion to $40 billion per year in today's economy); and add $130 billion to $210 billion to the capital stock.

Economic damage from the payroll tax can only be reduced by cutting the tax rate, not by playing with budget definitions. Social security should be included in the deficit computation and the Gramm-Rudman-Hollings deficit targets.

It is better to balance the total budget than to run large surpluses. Growth is best achieved by reducing tax rates.

The payroll tax rate should be cut cleanly and simply. It should not be entangled in complex tax credits, nor limited to the lower portion of covered income, or the economic gains will be reduced.

Payroll tax cuts should not be offset by increases in other taxes, or the economic gains will be lost. The Gramm-Rudman deficit targets should be changed to allow the rate cuts.

Waiting until the total budget is in surplus after 1993 would unnecessarily delay the economic gains. An immediate cut would produce only modest added debt service.

Future tax increases should not be included in the bill. The tax rate increases scheduled for 2012 and beyond in the Moynihan bill to cover rising OASDI benefits would reduce employment by 2 to 3 million below current law levels. The increases may be made unnecessary by increases in fertility, immigration, productivity, or benefits changes. Before passing judgment, it would be wise to ask future workers/retirees what they want in the way of retirement benefits and health benefits (which compete for the same revenue source -- also see the recommendations of the Pepper Commission), and how much tax they are willing to pay.

A payroll tax cut will not threaten benefits. OASDI will be running substantial surpluses for about 25 years, and would not need the spending authority in the trust funds in any event. Furthermore, the trust funds do not constitute money with which to pay future benefits, merely a promise that funds will be found in the future to pay benefits at that time. Regardless of the status of the trust funds, Congress will have to address the financing of the system as the baby boom retires, and as growing health care demands and soaring retirement benefits compete for payroll tax revenues which future workers will resist paying.

Discussion

The discussion of budget issues relating to social security has focused on how the system is treated for budget purposes and on charges that social security revenues are being used to finance the rest of the budget. Not enough attention has been paid to the economics of the payroll tax or of proposed adjustments.

Social security: out of the budget in name only

The economic damage done by the payroll tax cannot be eliminated by taking social security out of the deficit computation. The damage can only be reduced by lowering the tax rate.

The retirement and disability programs of social security (OASDI) are already considered off-budget for reporting purposes. However, OASDI surpluses are included in the definition of the deficit subject to the Gramm-Rudman-Hollings (GRH) deficit reduction targets, though OASDI outlays are not subject to sequester. If a balanced budget is the objective, OASDI surely should be included in the budget numbers.

OASDI tax receipts, outlays, surpluses, and deficits are part of total Federal taxing and spending, and affect the level of borrowing by the government in the credit markets. As such, OASDI surpluses and deficits affect the economy whether they are considered part of the Federal budget or recorded separately. The label attached to them is immaterial. Proposals to omit social security in computing the Federal deficit for GRH purposes must be viewed as an effort to put additional pressure for change on the rest of the budget, not as a technically superior method of computing the economic impact of the budget.

As the Congressional Budget Office has pointed out in its recent report, The Economic and Budget Outlook, "the flow of dollars into and out of trust funds affects the total government deficit that must be financed... Simply stated, the government has a deficit because it spends more money than it takes in. Any policy change that adds to revenues or reduces spending trims the deficit, and vice versa. This truth applies to trust fund programs just as it applies to the remainder of the budget. Nevertheless, attempts persist to portray the true deficit as the one that excludes trust funds. Trust funds, in this view, do not contribute to the deficit. These attempts are well-intentioned but misguided." [1]

CBO goes on to explode the myth that the general budget is being bailed out by the trust funds. There are over 150 federal trust funds dealing with earmarked spending. The only one in significant surplus is OASDI. The rest, such as Supplementary Medical Insurance (Medicare Part B), which is 75 percent funded out of general revenues, receive large transfers of funds from the general "federal funds" budget.

CBO states, "The federal funds deficit would look very different if it did not include large transfers to trust funds ... When such payments are excluded, the federal funds deficit shrinks by two-thirds over the 1990-1995 period, from about $104 billion at present to $35 billion in 1995. This pattern sharply contradicts one of today's budgetary fallacies: that official budget totals mask a growing trust fund surplus and a sharply deteriorating federal funds deficit."[2] In fact, it could as well be said that social security surpluses are financing the medicare and federal retirement systems rather than that they are hiding the "true deficit" in the general budget.

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[1]Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1991-1995, p.47. Washington, DC, U.S. Government Printing Office, January, 1990.

[2] Ibid., p. 52.

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CBO points out that trust fund revenues and outlays are an integral part of the federal government's taxing and spending policy, and that decisions affecting them have never been made in isolation. Perhaps the real objective of those who would misdefine the deficit is to isolate social security so that it would never have to compete for budget resources, nor play any role in deficit reduction in the future. They must beware, however, for OASDI faces horrendous long run deficits after the baby boom retires. At that time, OASDI will desperately need help from the rest of the budget, and turn-about is fair play.

Reasonable people can disagree as to whether economic growth is better served by budget balance or budget surpluses over the longer term. It is unreasonable, however, to twist accounting definitions to hide the true budget picture, and to call a surplus a deficit to force an increase in taxes.

Run surpluses or cut tax rates?

Under GRH, the total budget would be balanced by 1993. Some have proposed extending GRH to require that the non-OASDI portion of the budget be balanced by 1997. This would produce a total budget surplus just equal to the OASDI cash surplus, and result in the trust funds' buying up much of the national debt. The Administration supports a variant of this approach. The theory behind such proposals is that a budget surplus would raise national saving and investment, expand GNP, and make it easier to provide the real goods and services future retirees will demand.

In fact, a budget surplus is not a good way to promote economic expansion. It would be better to offset budding surpluses with reductions in tax rates on labor and capital.

National saving and investment would not be increased merely by running a Federal budget surplus. Spending restraint tends to increase national saving. Tax increases do not. Unnecessarily high tax rates would reduce private saving by roughly as much as the reduction in Federal borrowing, leaving national saving at best unchanged. Furthermore, many types of tax increases, such as might be enacted to balance the non-OASDI portion of the budget, would actively discourage investment by raising the cost of capital, or reduce employment by raising the cost of labor.

Private saving consists of personal saving, retained earnings of corporations, and capital consumption allowances (CCA -- depreciation of plant, equipment, and structures) of businesses. There is clearly no increase in national saving in the case of an increase in business taxes. These tax increases come dollar-for-dollar out of either retained earnings or out of the CCA. These changes not only cut the firm's income available for saving and investment, they also reduce the return on added capital and so

reduce desired investment. Tax increases at the individual level also do nothing to improve national saving, as they tend to depress personal saving rather than consumption by cutting into discretionary income. Some forms of personal tax increases also lower the incentive to save (marginal income tax rate increases, curtailment of IRAs and 410(k) plans, etc.), in addition to the adverse effect on disposable income.

The surest way to increase investment and the capital stock is to lower the cost of capital. At the business level, the best approach is to allow faster depreciation of plant and equipment for tax purposes. Expensing of capital (first year write-off) is ideal. On the personal tax side, saving incentives such as improved IRAs, reduced income tax rates, and a capital gains differential would lower the cost of capital. The cost of labor can be reduced by lowering payroll and income tax rates.

Economic gains from cutting the payroll tax

The payroll tax is an excise tax on labor. An increase in the payroll tax reduces employment by raising the cost of labor to the firm and reducing the after-tax reward to providers of labor services. With less labor available for capital to work with, the productivity of capital is lower, resulting in less investment and a smaller capital stock than would otherwise exist.

The adverse effect of higher payroll tax rates should be of particular concern to small businesses, insofar as small firms offer entry level jobs to individuals whose major tax burden is the payroll tax. There should be further concern that the most recent increase in the payroll tax has come at a time when the minimum wage is beginning a series of large increases.

Employment is heavily influenced by small business hiring. The Small Business Administration estimates that, between 1980 and 1986, 63.5 percent or 6.6 million of the new jobs created were in firms with fewer than 500 workers, and 38.7 percent or about 4 million new jobs were in firms with less than 20 employees. The figures would be much higher if one counted individual franchises of national chains as independent businesses.

The combined payroll tax (OASDI and HI) rose from 14.3% of payroll in 1987 to 15.3% of payroll in 1990 as a result of the 1988 and 1990 increases. This 1 percentage point increase in the tax rate will result in roughly 400,000 to 500,000 fewer jobs in the economy by the year 2000 than if there were no such increase, and a roughly $80 billion to $100 billion reduction in productive capital. A drop in the payroll tax rate would produce corresponding increases in employment and GNP.

The Moynihan proposal. The Moynihan proposal would reduce the payroll tax by 2.2% of payroll by 1991 (table 1). It would save about 900,000 to 1.1 million jobs over ten years, relative to the level of employment under current law. The Moynihan proposal would raise GNP by about 0.6%, once all adjustments were made. In terms of current GNP, this would be about $35 billion to $40 billion per year. The capital stock would be about $160 billion to $210 billion higher over ten years.

The Kasten proposal. The Kasten proposal would reduce the payroll tax by 1.8% of payroll by 1992 (table 1). It should save about 700,000 to 900,000 jobs over ten years, relative to the level of employment under current law. The Kasten proposal would raise GNP by about 0.5%, once all adjustments were made. In terms of current GNP, this would be almost $30 billion per year. The proposal would increase the capital stock by about $130 billion to $180 billion over ten years.

Future tax increases

The GNP and employment gains will last only as long as the tax rate reductions. The tax rate increases scheduled for 2012 and beyond in the Moynihan bill to cover rising OASDI benefits would increase the OASDI portion of the payroll tax to 16.2 percent of payroll, nearly 4 percentage points above current levels. This would reduce employment by 2 to 3 million below current law levels in the decades after the baby boom retires, unless the tax increases are rendered unnecessary by increases in fertility, immigration, productivity, or adjustments to benefits. Sharply higher immigration could make an enormous difference in the projections.

It would be wise not to enact OASDI payroll tax increases at this time to take effect in distant decades. At some point, it will be necessary to consider the relationship between retirement benefits and Medicare benefits, and the degree to which the payroll tax may have to be raised in the future to finance Medicare or some alternative (see the recommendations of the Pepper Commission). Also, the current retirement benefit formula provides for an increase of between 150 percent and 200 percent in real per capita benefits for new retirees over the next 75 years (table 2). Whether future generations will prefer higher taxes or reduced benefit growth, or choose to emphasize health or retirement benefits, is as yet unclear.

Cut the tax rate cleanly

If the payroll tax is to be cut, it should be cut cleanly and simply. It should not be entangled in tax credits, nor limited to the lower portion of covered income.

Unless the rate is reduced over the whole contribution base ($51,300), those above whatever cut-off point is chosen will not receive a reduction in the marginal tax burden and will have no incentive to increase their work effort. There will similarly be no reduction in the cost of such labor to the firm.

Use of a tax credit has similar non-marginal drawbacks, in addition to adding another layer of complexity to the tax code. It should be remembered that the earned income tax credit (EITC) was created to offset a portion of the payroll tax for lower income workers with dependent children, and that the EITC was increased significantly in the Tax Reform Act of 1986.

Payroll tax reduction and the deficit

Payroll tax reduction is complicated by the GRH deficit reduction targets. The best course is to amend the targets to accommodate the rate reductions.

Raising other taxes. Payroll tax reductions should not be financed by raising other taxes. Instead, Congress should reserve some of the $80 billion increase in revenues each year from a growing economy for tax rate reductions aimed at promoting further growth.

Raising other taxes would destroy the economic gains from payroll tax relief. Because of the higher and graduated rate structure of the income tax, an offsetting income tax rate increase, or an increase in the level of wages subject to the payroll tax, would lower the after-tax wage and reduce work effort and GNP by more than the lower payroll tax rate would increase them.

Small businesses would surely not be helped by an income tax rate increase for the proprietor, nor by more severe tax treatment of equipment and inventory. In addition, small business would gain disproportionately from a reduction in the double taxation of capital gains. Cutting both the payroll tax and the capital gains rate would make a good small business tax relief package.

Delaying the cut. It would not pay to delay the payroll tax cut until 1993 or later, when the total budget will presumably be moving into surplus. Delaying the rate cut would delay the economic gains, and is not necessary. If the payroll tax were cut now, producing a bigger deficit through 1993, there would be only a limited increase in the national debt. The higher budget cost due to the added debt service would be modest, especially after factoring in the taxes paid on the incremental GNP. The gain in GNP would be much larger than the net budget loss.

The Moynihan proposal. The Moynihan proposal does not change the budget treatment of OASDI or the GRH targets. Presumably, some change in other taxes or outlays would have to be made to allow the payroll tax rate reductions. The proposal would add about $275 billion to the Federal debt through 1993 if there were no offsetting tax or spending changes. The interest on this sum, at 7%, would be about $19.25 billion per year after 1993. The employment and GNP gains from the rate cut would add over $12 billion to annual Federal tax receipts in the later part of the decade, offsetting 60 percent of the long-term budget impact.

The Kasten proposal. The Kasten proposal raises the GRH deficit targets by the amount of the payroll tax reductions, and extends those targets to produce a balanced non-OASDI budget by 1997. The proposal would add roughly $225 billion to the Federal debt over this period. The interest on this sum, at 7%, would be about $15.75 billion per year after 1993. The employment and GNP gains from the rate cut would add more than $9 billion to annual Federal tax receipts in the later part of the decade, offsetting 60 percent of thelong-term budget impact.

A payroll tax cut will not threaten benefits.

OASDI trust fund reserves would be less under a payroll tax rollback than under current law. However, this will not make future benefits less secure, and should not be viewed as an obstacle to a tax rate cut.

OASDI will be running substantial surpluses for about 25 years, and would not need the spending authority in the trust funds in any event. Furthermore, the trust funds do not constitute money with which to pay future benefits, merely a promise that funds will be found in the future to pay benefits at that time. The trust funds represent nothing more than budget authority -- the authority for the Social Security Administration (SSA) to order Treasury to issue benefits checks, and to use either general revenues or borrowing from the credit markets to do so. This amount of future spending and borrowing with have a major impact on the economy at that time, and Congress will have to consider this impact at that time whether a trust fund exists or not.

The spending authority which social security gets from its dedicated payroll and income tax receipts and from its trust funds is designed chiefly to make it unnecessary for SSA go to Congress each year for an appropriation to pay benefits. SSA may direct Treasury to spend up to the amount in the trust funds before going back to the Congress for more spending authority.

The size of the trust funds is quite arbitrary. In the past, it has been tied to the level of excess payroll taxes, plus interest, but that is not necessary. To see the arbitrary nature of

the trust funds, consider that Congress could have set a higher or lower interest rate to be paid on the amounts in the trust funds, or that it could pass a bill to double or halve the trust funds overnight independently of current receipts and outlays.

The OASDI contingency fund ratio (the trust fund assets, beginning of year, as a percent of the year's projected outlays on benefits) was estimated to be 77 percent for 1990, 98 percent for 1991, and in excess of 160 percent by 1994 under the Alternative II-B assumptions in the 1989 OASDI Trustees Report (OASDI Report, Table 31). The OASDI trust funds will peak at nearly 550 percent of a year's outlays in about 2015.

This sharp increase in the reserve ratio was an unintended byproduct of the 1983 Amendments. Congress focused on the short run financing problem of OASDI in the mid-1980s, and did not request or receive detailed projections of what the Amendments would do to the reserves in the decades beyond 1990. While it was known that the reserves and the reserve ratio would build somewhat thereafter, the extent of the dollar buildup was not made clear until the publication of the figures in a subsequent series of "actuarial notes" in the months and years after the 1983 Amendments became law. There was no widespread recognition of the situation until the "notes" became part of the annual OASDI Trustees Report in 1988.

Some observers would like the ratio to increase to between 150 percent and 200 percent of a year's outlays before any tax rate reductions are enacted. A large reserve is not needed to ensure benefit payments; the minimum required ratio for that is well under 10 percent. (Indeed, since the 1983 Amendments, Treasury has credited OASDI with its monthly revenues at the start of each month rather than as the revenues are received during the month, further reducing the need for a reserve.) A higher ratio may give Congress more time to act should an unexpected dip in the economy cause revenues to fall below benefit payments. However, it would take a severe recession to produce a decline in the current ratio even if tax rates were set just to cover current outlays under normal economic conditions. A ratio in the neighborhood of 75 to 100 percent is more than adequate. It would give OASDI 4 to 5 years' spending authority even if receipts fell 20 percent below outlays. A shortfall of that magnitude would only occur as a result of the major demographic crisis facing the system as the baby boom retires. No reasonable reserve would be adequate to deal with that problem, which in any event can be predicted decades in advance.

The Moynihan Proposal. The Moynihan proposal would reduce the payroll tax by approximately the margin of projected cash surpluses in the OASDI trust funds over the next 20 to 25 years under the Alternative II-B assumptions in the 1989 OASDI Trustees Report. The trust funds would still grow with interest from the

Treasury on its current holdings. However, the combined OASDI trust fund reserve ratio would not rise above current levels.

The Kasten Proposal. The Kasten proposal does not cut the OASDI tax by quite the full margin of projected cash surpluses in the OASDI trust funds over the next 20 to 25 years under the Alternative II-B assumptions in the 1989 OASDI Trustees Report. As a result, the combined OASDI trust fund reserve ratio would continue to increase slowly over that time period, exceeding 100 percent by 1992 and approaching 200 percent by 2010.

Is the payroll tax regressive?

The Committee has asked for views on whether the payroll tax is regressive. Arguments for cutting the payroll tax are better made on the basis of the tax's adverse effect on employment than on issues of regressivity.

The payroll tax should not be looked at in isolation and labeled "regressive." It must be viewed either as part of social security or as part of the tax code. OASDI retirement benefits are far higher as a percent of earnings for low income recipients than for high income recipients, and the combined effect of the benefit and tax formulas is a highly progressive system.

The payroll tax is one of many taxes. It is one of the flattest taxes we have, neither regressive nor progressive over 93 percent of the population and 87 percent of covered income. Combined with the progressive income tax and the multiple taxation of capital income, it is part of a generally progressive tax system.

There is no need to make each component of the tax system independently progressive. The Congress presumably set the appropriate degree of tax progressivity when it restructured income tax rates and altered the tax base in the 1986 Tax Reform Act. At that time, several million low-income taxpayers were dropped from the income tax rolls. The higher taxes imposed on capital in 1982, 1984, and 1986 also increased progressivity. Furthermore, the 1981 and 1986 tax acts reduced marginal income tax rates in a manner which encouraged earning and reporting of more income by middle and upper income taxpayers. The upper-income have paid an increasing share of the income tax since the 1981 act was passed, and it is expected that the same phenomenon will be seen as a result of the 1986 Tax Reform Act.

The payroll tax itself has been paid increasingly by upper-income taxpayers. Over the last ten to twenty years, there has been rapid growth of two-earner households. These naturally tend to have higher family income than one-earner households. If the primary earner in a family has wage or salary income above the taxable wage base, the entry of the spouse into the labor force

generally raises the payroll tax as a share of family income, unless the spouse's earnings exceed the wage base to an equal degree. Spouses often get a bad deal in being subject to the payroll tax, in that they were already eligible for a spousal benefit under social security without having to pay the tax, and the added benefits based on their own earnings may not be large relative to the tax paid. This phenomenon increases the over-all progressivity of the social security program, insofar as two-earner families are wealthier than one-earner families, but it does not make the program fairer.

Effect of lifting the cap. Proposals to end the supposed regressivity of the payroll tax by eliminating the maximum covered wage are misguided. The amount of income subject to the payroll tax (now $51,300) is called the "contribution and benefit base." A worker's retirement benefits are based on his lifetime taxable earnings, and any earnings up to the level of the benefit base are counted in determining those benefits. If the base is raised, near-term "contributions" will rise, but so will long-term benefits. Eventually, higher benefits would absorb over 80 percent of the added revenue. Meanwhile, deductibility of half of the payroll tax increase by firms or the self-employed would depress income tax receipts, offsetting nearly all of the remaining net revenue gain from lifting the cap.

Raising the cap would reduce the after-tax wage of upper income workers by about 16 percent at the margin, when the marginal federal and state income tax rates are factored into the calculation. Even a trivial reduction in work effort by the affected group in response to this disincentive would reduce payroll and income tax receipts by enough to wipe out any remaining budget improvement from lifting the cap. Social security might be slightly better off, but the total budget would be significantly deeper in deficit in the long run.

Is the payroll tax inflationary?

The Committee has asked whether the payroll tax is inflationary. The payroll tax, like the income tax and taxes on capital, is a real cost of doing business. A rise in the payroll tax raises labor costs on a once-and-for-all basis, employment and output drop to a lower level, and the price level receives a one-time boost. This is not the same as a continuing rise in the price level due to excessive ongoing rates of money creation, and does not constitute inflation. The Federal Reserve should not view the tax increase as inflationary, and should not reduce money supply growth to fight the price effect. Conversely, the Federal Reserve should not boost money growth in response to the employment reduction, as faster money growth cannot offset an increase in the real cost of production. Indeed, faster money growth would spur inflation and raise the cost of capital. The cost of

capital would rise because the income tax falls on nominal interest and capital gains, and because the capital consumption allowances are not indexed for inflation.

Is the payroll tax the appropriate means to finance retirement and medicare benefits?

The Committee has asked whether the payroll tax is an appropriate means for financing OASDI and Medicare. If OASDI and Medicare were intended to provide a fixed basket of retirement and insurance services, the price charged should be similar to that of a private company offering the same product. (Indeed, the business should be left to the private sector whenever possible.) This means charging the same price to all buyers. However, OASDI and Medicare are not set up this way.

If OASDI benefits were proportional to tax contributions or to taxable earnings during one's working life, a flat tax rate would be appropriate. However, the benefit formula is tilted heavily toward low income recipients. This welfare element of OASDI benefits might better be borne by the income tax. The remaining benefits would take on the characteristics of an annuity, with the cost per unit of future income the same for all buyers within a generation. However, since each generation is paying for the benefits of the generation that preceded it, rather than its own benefits, the cost will change over time. As the ratio of workers to retirees declines, the ratio of taxes paid to benefits received will fall for future generations. This would be true regardless of which tax is raised to pay scheduled benefits, and reflects OASDI's demographic difficulties, not the choice of the payroll tax as the financing mechanism.

Medicare Part A (Hospital Insurance -- HI) provides a fixed basket of hospital services for all retirees, but charges people during their working lives for this future coverage, and charges higher income workers more than lower income workers. This gives HI a welfare element which might better be borne by the income tax. To mimic the private sector, the remaining expense would be covered by a fixed group premium paid by persons of all ages. (One of the chief complaints of the elderly against Catastrophic Coverage was that the heavy welfare element of that program -- including the cost of outlays for the non-elderly disabled and outlays for the elderly poor now covered largely by Medicaid -- was placed on the shoulders of middle and upper income enrollees, instead of on the general population as at present.)

Medicare Part B (Supplemental Medical Insurance -- SMI) covers doctors' visits and outpatient care for a set premium per enrollee, which is proper as far as it goes. However, SMI is over 75 percent funded by general revenues, so that rich and poor receive a substantial subsidy.

Table 1

OASDI Tax Rates, Current Law,
Moynihan and Kasten Proposals
(employee and employer, each)

current law:
1990 and beyond 6.2%

Moynihan proposal:
1990 ..... 6.06%
1991 through 2011 ... 5.1%
2012 through 2014 ... 5.6%
2015 through 2019 ... 6.2%
2020 through 2024 ... 7.0%
2025 through 2044 ... 7.7%
2045 and beyond 8.1%

Kasten proposal:
1990 ..... 5.9%
1991 ..... 5.6%
1992 and beyond .. 5.3%

Table 2

ESTIMATED INITIAL BENEFIT AMOUNT PAYABLE TO RETIRED WORKERS WITH AVERAGE AND MAXIMUM PRE-RETIREMENT EARNINGS LEVELS 1/

	Annual Benefits, Real 1989 Dollars			
	Normal retirement 2/		Age 65 retirement	
Retirement Year	Average earnings	Maximum earnings 3/	Average earnings	Maximum earnings 3/
1990	$8,286	$11,210	$8,286	$11,210
2000	9,162	13,208	9,162	13,208
2010	10,305	15,829	9,682	14,898
2025	12,355	19,398	10,833	17,075
2045	15,841	24,874	13,890	21,896
2065	20,309	31,883	17,807	28,065

1/ From Table F6, 1989 OASDI Trustees Report. II-B Assumptions.
2/ Statutory "normal" retirement age rises from 65 to 67 under 1983 Amendments.
3/ Maximum Earnings equal to SSA contribution and benefit base.

SECURITY IN YOUR OLD AGE

SOCIAL SECURITY BOARD
Washington, D. C.

I. S. C. 9

To Employees of Industrial and Business Establishments

FACTORIES • SHOPS • MINES • MILLS • STORES

OFFICES AND OTHER PLACES OF BUSINESS

Beginning November 24, 1936, the United States Government will set up a Social Security account for you, if you are eligible. To understand your obligations, rights, and benefits you should read the following general explanation.

THERE is now a law in this country which will give about 26 million working people something to live on when they are old and have stopped working. This law, which gives other benefits, too, was passed last year by Congress and is called the Social Security Act.

Under this law the United States Government will send checks every month to retired workers, both men and women, after they have passed their 65th birthday and have met a few simple requirements of the law.

WHAT THIS MEANS TO YOU

THIS means that if you work in some factory, shop, mine, mill, store, office, or almost any other kind of business or industry, you will be earning benefits that will come to you later on. From the time you are 65 years old, or more, and stop working, you will get a Government check every month of your life, if you have

worked some time (one day or more) in each of any 5 years after 1936, and have earned during that time a total of $2,000 or more.

The checks will come to you as a right. You will get them regardless of the amount of property or income you may have. They are what the law calls "Old-Age Benefits" under the Social Security Act. If you prefer to keep on working after you are 65, the monthly checks from the Government will begin coming to you whenever you decide to retire.

The Amount of Your Checks

How much you will get when you are 65 years old will depend entirely on how much you earn in wages from your industrial or business employment between January 1, 1937, and your 65th birthday. A man or woman who gets good wages and has a steady job most of his or her life can get as much as $85 a month for life after age 65. The least you can get in monthly benefits, if you come under the law at all, is $10 a month.

IF YOU ARE NOW YOUNG

Suppose you are making $25 a week and are young enough now to go on working for 40 years. If you make an average of $25 a week for 52 weeks in each year, your check when you are 65 years old will be $53 a month for the rest of your life. If you make $50 a week, you will get $74.50 a month for the rest of your life after age 65.

IF YOU ARE NOW MIDDLE-AGED

But suppose you are about 55 years old now and have 10 years to work before you are 65. Suppose you make only $15 a week on the average. When you stop work at age 65 you will get a check for $19 each month for the rest of your life. If you make $25 a week for 10 years, you will get a little over $23 a month from the Government as long as you live after your 65th birthday.

IF YOU SHOULD DIE BEFORE AGE 65

If you should die before you begin to get your monthly checks, your family will get a payment in cash, amounting to 3½ cents on every dollar of wages you have earned after 1936. If, for example, you should die at age 64, and if you had earned $25 a week for 10 years before that time, your family would receive $455. On the other hand, if you have not worked enough to get the regular monthly checks by the time you are 65, you will get a lump sum,

or if you should die your family or estate would get a lump sum. The amount of this, too, will be 3½ cents on every dollar of wag you earn after 1936.

TAXES

THE same law that provides these old-age benefits for you and other workers, sets up certain new taxes to be paid to the United States Government. These taxes are collected by the Bureau of Internal Revenue of the U. S. Treasury Department, and inquiries concerning them should be addressed to that bureau. The law also creates an "Old-Age Reserve Account" in the United States Treasury, and Congress is authorized to put into this reserve account each year enough money to provide for the monthly payments you and other workers are to receive when you are 65.

YOUR PART OF THE TAX

The taxes called for in this law will be paid both by your employer and by you. For the next 3 years you will pay maybe 15 cents a week, maybe 25 cents a week, maybe 30 cents or more, according to what you earn. That is to say, during the next 3 years, beginning January 1, 1937, you will pay 1 cent for every dollar you earn, and at the same time your employer will pay 1 cent for every dollar you earn, up to $3,000 a year. Twenty-six million other workers and their employers will be paying at the same time.

After the first 3 years—that is to say, beginning in 1940—you will pay, and your employer will pay, 1½ cents for each dollar you earn, up to $3,000 a year. This will be the tax for 3 years, and then, beginning in 1943, you will pay 2 cents, and so will your employer, for every dollar you earn for the next 3 years. After that, you and your employer will each pay half a cent more for 3 years, and finally, beginning in 1949, twelve years from now, you and your employer will each pay 3 cents on each dollar you earn, up to $3,000 a year. That is the most you will ever pay.

YOUR EMPLOYER'S PART OF THE TAX

The Government will collect both of these taxes from your employer. Your part of the tax will be taken out of your pay. The Government will collect from your employer an equal amount out of his own funds.

This will go on just the same if you go to work for another employer, so long as you work in a factory, shop, mine, mill, office, store, or other such place of business. (Wages earned in employment as farm workers, domestic workers in private homes, Government workers, and on a few other kinds of jobs are not subject to this tax.)

OLD-AGE RESERVE ACCOUNT

Meanwhile, the Old-Age Reserve fund in the United States Treasury is drawing interest, and the Government guarantees it will never earn less than 3 percent. This means that 3 cents will be added to every dollar in the fund each year.

Maybe your employer has an old-age pension plan for his employees. If so, the Government's old-age benefit plan will not have to interfere with that. The employer can fit his plan into the Government plan.

What you get from the Government plan will always be more than you have paid in taxes and usually more than you can get for yourself by putting away the same amount of money each week in some other way.

Note.—"Wages" and "employment" wherever used in the foregoing mean wages and employment as defined in the Social Security Act.

WHERE TO GET MORE INFORMATION

If you want more information, write to the *Social Security Board, Washington, D. C.*, or get in touch with one of the following offices:

REGION I—Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, and Connecticut:
Social Security Board
120 Boylston Street
Boston, Mass.

REGION II—New York:
Social Security Board
45 Broadway
New York, N. Y.

REGION III—New Jersey, Pennsylvania, and Delaware:
Social Security Board
Widener Building
Juniper and Chestnut Streets
Philadelphia, Pa.

REGION IV—Virginia, West Virginia, North Carolina, Maryland, and District of Columbia:
Social Security Board
National Theatre Building
Washington, D. C.

REGION V—Kentucky, Ohio, and Michigan:
Social Security Board
Bulkley Building
1501 Euclid Avenue
Cleveland, Ohio

REGION VI—Illinois, Indiana, and Wisconsin:
Social Security Board
211 West Wacker Drive
Chicago, Ill.

REGION VII—Tennessee, Mississippi, Alabama, Georgia, Florida, and South Carolina:
Social Security Board
1829 First Avenue North
Birmingham, Ala.

REGION VIII—Iowa, Minnesota, North Dakota, South Dakota, and Nebraska:
Social Security Board
New Post Office Building
Minneapolis, Minn.

REGION IX—Missouri, Kansas, Arkansas, and Oklahoma:
Social Security Board
Dierks Building
1006 Grand Avenue
Kansas City, Mo.

REGION X—Louisiana, Texas, and New Mexico:
Social Security Board
Smith-Young Tower Building
San Antonio, Tex.

REGION XI—Montana, Idaho, Utah, Colorado, Arizona, and Wyoming:
Social Security Board
Patterson Building
1706 Welton Street
Denver, Colo.

REGION XII—California, Oregon, Washington, and Nevada:
Social Security Board
Humboldt Bank Building
785 Market Street
San Francisco, Calif.

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27-725 (88)